PART VII: INDIVIDUAL RETIREMENT PLANS

In General

3602. What is an individual retirement account? What is a Roth individual retirement plan?

A traditional individual retirement plan is a personal retirement savings program toward which eligible individuals may contribute both deductible and nondeductible payments with the benefit of tax-deferred buildup of income.

A Roth individual retirement plan is a personal retirement savings program for which eligible individuals may contribute only nondeductible payments with the potential benefit of tax-free buildup of income (Q 3626). A Roth individual retirement plan must clearly be designated as such at the time of establishment, and that designation cannot later be changed; the recharacterization of a Roth IRA will require the execution of new documents (Q 3617).[1]

With respect to both traditional and Roth individual retirement plans, some individuals also may contribute to such plans for their spouses (Q 3612).

There are two kinds of traditional and Roth individual retirement plans: individual retirement accounts, and individual retirement annuities (Q 3603).

Individual Retirement Account

An individual retirement account is a written trust or custodial account.[2] Contributions to such accounts must be in cash (except for rollovers) and may not exceed the maximum annual contribution limit for the tax year – except for rollover contributions (Q 3880), for contributions to a SIMPLE IRA (Q 3654), and for employer contributions to simplified employee pensions (Q 3650).[3] A wire order from a broker to a custodian will constitute a "cash contribution" on the date payment and registration instructions are received by the broker, provided an agency arrangement recognized by and binding under state law exists between the broker and the custodian.[4]

The trustee or custodian of an individual retirement account must be a bank, a federally insured credit union, a building and loan association, or an entity that satisfies IRS requirements.[5] A trustee or custodian acceptable to the IRS cannot be an individual but can be a corporation or partnership that demonstrates that it has fiduciary ability (including continuity of life, established location, fiduciary experience, and fiduciary and financial responsibility), capacity to account for the interests of a large number of individuals, fitness to handle retirement funds, ability to administer fiduciary powers (including maintenance of a separate trust division), and adequate net worth (at least $250,000 initially).[6]

1. IRC Sec. 408A(b); Treas. Reg. §1.408A-2, A-2.
2. IRC Secs. 408(a), 408(h), 408A(a).
3. IRC Sec. 408(a)(1).
4. Let. Ruls. 9034068, 8837034.
5. IRC Secs. 408(a)(2), 408(n).
6. Treas. Regs. §§1.408-2(b)(2), 1.408-2(e).

The interest of the individual in the balance of his or her individual retirement account must be nonforfeitable, and the assets must not be commingled with other property except in a common trust fund or common investment fund. In such a trust, they may be pooled with trust funds of regular qualified plans.[1] No part of the trust funds may be invested in life insurance.[2] An account generally may not invest in collectibles without adverse tax consequences (Q 3608). An account may invest in annuity contracts that, in the case of death prior to the time distributions commence, provide for a payment equal to the sum of the premiums paid or, if greater, the cash value of the contract.[3] An account may not use any part of its assets to purchase an endowment contract issued after November 6, 1978.[4] With respect to traditional individual retirement accounts, distribution of an individual's interest must begin by April 1 of the year after the year in which he or she reaches age 70½ and must be made over a limited period. In addition, distributions must comply with the incidental death benefit requirements of IRC Section 401(a)(9) (Q 3637).[5] With respect to both traditional and Roth accounts, required minimum distribution requirements must be met upon death of the owner (Q 3638).[6]

Planning Point: Effective for tax years beginning after December 31, 2012, distributions from individual retirement arrangements (as well as from qualified plans, Code section 403(b) tax-sheltered annuities, and eligible 457 governmental plans) are excepted from the new unearned income Medicare contribution tax imposed under the Affordable Care Act[7]. The ACA imposes a tax of 3.8 percent on individuals, estates, and trusts on the lesser of net investment income, or the excess of modified adjusted gross income (AGI + foreign earned income) over a threshold of $200,000 (individual) or $250,000 (joint). Investors may therefore find it beneficial to direct wages and investments into IRAs to reduce income and remain below these thresholds.[8]

3603. What is an individual retirement annuity?

This may be an annuity or an endowment contract issued by an insurance company.[9] An endowment contract issued after November 6, 1978 will not qualify.[10] The contract must be nontransferable. A contract will be considered transferable if it can be used as security for any loan other than a loan from the issuer in an amount not greater than the cash value of the contract. Even so, a policy loan would cause the contract to cease to be an individual retirement annuity or endowment contract as of the first day of the owner's tax year in which the loan was made (Q 3608).[11] Contracts issued after November 6, 1978, may not have fixed premiums.[12] The annual premium on behalf of any individual may not exceed the maximum annual contribution limit for the tax year except in the case of a SIMPLE IRA (Q 3654) or a simplified employee pension (Q 3650).[13]

1. IRC Secs. 408(a)(4), 408(a)(5), 408(e)(6); Rev. Rul. 81-100, 1981-1 CB 326; see also *Nichola v. Comm.*, TC Memo 1992-105.
2. IRC Sec. 408(a)(3).
3. Treas. Reg. §1.408-2(b)(3).
4. Treas. Regs. §§1.408-4(f), 1.408-3(e)(1)(ix).
5. IRC Secs. 408(a)(6), 408A(c)(5).
6. IRC Secs. 408(a)(6), 408A(c)(5).
7. P.L. 111-148.
8. See IRC Sec. 1411.
9. IRC Secs. 408(b), 408A(a).
10. Treas. Reg. §1.408-3(e)(1)(ix).
11. IRC Sec. 408(e)(3); Treas. Reg. §1.408-3(c).
12. IRC Sec. 408(b)(2)(A).
13. IRC Sec. 408(b)(2)(B).

Any refund of premium must be applied to the payment of future premiums or the purchase of additional benefits before the close of the calendar year of the refund.[1] The interest of the owner must be nonforfeitable.[2] With respect to traditional individual retirement annuities, distribution must begin by April 1 of the year after the year in which the owner reaches age 70½ and the period over which distribution may be made is limited. In addition, distributions must comply with the incidental death benefit requirements of IRC Section 401(a)(9) (Q 3637).[3] With respect to both traditional and Roth annuities, required minimum distribution requirements must be met on the owner's death (Q 3638).[4]

The IRS has privately ruled that a contract that includes a substantial element of life insurance will not qualify as an individual retirement annuity.[5]

Proposed regulations state that for a flexible premium annuity to qualify as an individual retirement annuity, the contract must provide that (1) at no time after the initial premium has been paid will a specified renewal premium be required, (2) the contract may be continued as a paid-up annuity under its nonforfeiture provision if premium payments cease altogether, and (3) if the contract is continued on a paid-up basis, it may be reinstated at any date prior to its maturity date by a payment of premium to the insurer.

Two exceptions allow the insurer to set a minimum premium, not in excess of $50, and to terminate certain contracts where premiums have not been paid for an extended period and the paid-up benefit would be less than $20 a month.

A flexible premium contract will not be considered to have fixed premiums merely because a maximum annual premium is set, an annual charge is placed against the policy value, or because the contract requires a level annual premium for supplementary benefits (such as a waiver of premium feature).[6]

A participation certificate in a group annuity contract meeting the above requirements will be considered an individual retirement annuity if there is a separate accounting for the benefit allocable to each participant-owner and the group contract is for the exclusive benefit of the participant-owners and their beneficiaries.[7]

A "wraparound annuity" contract entered into on or before September 25, 1981 as an individual retirement annuity will continue to be treated for tax purposes as an individual retirement annuity provided no contributions are made on behalf of any individual who was not included under the contract on that date. "Wraparound annuity" refers to an insurance company contract containing typical deferred annuity provisions but that also promises to allocate net premiums to an account invested in shares of a specific mutual fund that is available to the general public without purchase of the annuity contract.[8]

1. IRC Sec. 408(b)(2)(C).
2. IRC Sec. 408(b)(4).
3. IRC Secs. 408(b)(3), 408A(c)(5).
4. IRC Secs. 408(a)(6), 408A(c)(5).
5. Let. Rul. 8439026.
6. Prop. Treas. Reg. §1.408-3(f).
7. Treas. Reg. §1.408-3(a).
8. Rev. Rul. 81-225, 1981-2 CB 12, as clarified by Rev. Rul. 82-55, 1982-1 CB 12.

Effective November 16, 1999, annuity contracts in which the premiums are invested at the direction of the IRA owners in "publicly available securities" (i.e., mutual funds that are available for public purchase) will be treated as an individual retirement annuity contract if no additional federal income tax liability would have been incurred if the owner had instead contributed such amount into an individual retirement account where the funds were commingled in a common investment fund.[1]

3604. What are retirement bonds?

Prior to TRA '84, the IRC provided for the issuance of retirement bonds.[2] These were issued by the U.S. government, with interest to be paid on redemption. Sales of these bonds were suspended as of April 30, 1982.[3] Subsequently, the Treasury Department announced that existing bonds could be redeemed by their holders at any time without being subject to an early distribution penalty (Q 3629).[4] Existing bonds also can be rolled over into other individual retirement plans under rules applicable to rollovers from individual retirement plans (Q 3891).[5]

3605. What is a "deemed IRA"?

For plan years beginning after December 31, 2002, a qualified plan, Section 403(b) tax sheltered annuity plan, or eligible Section 457 governmental plan may allow employees to make voluntary employee contributions to a separate account or annuity established under the plan. If such account or annuity meets the rules for traditional IRAs under IRC Section 408 or for Roth IRAs under IRC Section 408A, then such account or annuity will be "deemed" an IRA and not a qualified employer plan. A voluntary employee contribution is any non-mandatory contribution that the individual designates as such. Such "deemed IRAs" will not be subject to the IRC rules governing the employer plan, but they will be subject to the exclusive benefit and fiduciary rules of ERISA to the extent they otherwise apply to the employer plan.[6]

Under final regulations, a deemed IRA and the plan under which it is adopted generally are treated as separate entities, with each subject to the rules generally applicable to that type of entity.[7] The regulations further provide that the "availability of a deemed IRA is not a benefit, right, or feature of the qualified employer plan," meaning that eligibility for and contributions to deemed IRAs are not subject to the general nondiscrimination requirements applicable to qualified plans.[8]

The regulations provide three exceptions to treating a qualified plan and deemed IRAs as separate entities.

First, the qualified plan documents must contain the deemed IRA provisions and be in effect at the time the deemed IRA contributions are accepted. (Plans offering deemed IRAs for the 2002 or 2003 plan years had until the plan year beginning in 2004 to have such provisions in writing).[9]

1. Rev. Proc. 99-44, 1999-2 CB 598, modifying Rev. Rul. 81-225, 1981-2 CB 12.
2. IRC Sec. 409, as in effect prior to repeal by TRA '84.
3. Treasury Release (4-27-82).
4. Treasury Announcement (7-26-84).
5. IRC Sec. 409(b)(3)(C), prior to repeal.
6. IRC Sec. 408(q). See Rev. Proc. 2003-13, 2003-1 CB 317.
7. Treas. Reg. §1.408(q)-1.
8. Treas. Reg. §1.408(q)-1(f)(6).
9. Treas. Reg. §1.408(q)-1(d)(1).

Second, deemed IRA and qualified plan assets may be commingled. The prohibition against commingling in IRC Section 408(a)(5) (Q 3602) does not apply to deemed IRA and qualified plan assets. Deemed IRA and qualified plan assets still may not be further commingled with non-plan assets.[1]

Third, if deemed IRA and qualified plan assets are commingled in a single trust, the failure of any of the deemed IRAs maintained by a plan to meet the requirements of IRC Section 408 (traditional IRAs) or IRC Section 408A (Roth IRAs) can disqualify the qualified plan, requiring correction through the Employee Plans Compliance Resolution System or another administrative procedure (Q 3758). Likewise, the disqualification of a plan can cause the individual accounts to no longer be considered as deemed IRAs.[2]

If deemed IRA and qualified plan assets are maintained in separate trusts, a qualified plan will not be disqualified solely because of the failure of any of the deemed IRAs to meet the requirements of IRC Section 408 (traditional IRAs) or IRC Section 408A (Roth IRAs). Likewise, if separate trusts are maintained, individual accounts will not fail to be deemed IRAs solely because of the disqualification of the plan.[3]

Planning Point: It may be preferable to create IRAs outside a qualified plan or use separate trusts to avoid any possibility of either the IRA or the qualified plan causing disqualification of the other.

3606. What information must be provided to a buyer of an IRA?

A "disclosure statement" and a copy of the governing instrument must be furnished to the individual at least seven days before the plan is purchased or established, whichever is earlier, or as late as the time it is purchased or established, whichever is earlier, if the individual is permitted to revoke the plan within at least seven days. An individual revoking his or her plan is entitled to the return of the full amount he or she paid without adjustment for sales commission, administrative expenses, or fluctuation in market value. If the governing instrument is amended after the IRA is no longer subject to revocation, a copy of the amendment (and possibly a "disclosure statement") must be furnished to the individual not later than the 30th day after the later of the date the amendment is adopted or becomes effective.[4]

IRS regulations also provide that, if values under an individual retirement arrangement are guaranteed or can be projected, the trustee or issuer must in certain instances disclose to an IRA purchaser the amounts guaranteed or projected to be withdrawable. Basically, these regulations provide that the trustee must show the owner the amount the owner could receive if he or she closed the account and paid any surrender charges or penalties, at the end of each of the first five years after the initial contribution and at ages 60, 65, and 70.[5] In making the disclosure, the trustee must show the amount guaranteed (or projected) to be withdrawable, after reduction for all charges or penalties that may be applied. The disclosures required for values at an owner's ages 60, 65, and 70

1. Treas. Reg. §1.408(q)-1(d)(2).
2. Treas. Reg. §1.408(q)-1(g).
3. Treas. Reg. §1.408(q)-1(g).
4. Treas. Reg. §1.408-6(d)(4).
5. Treas. Reg. §1.408-6(d)(4)(v).

must be based on the actual age of the individual at the time of the disclosure. If a guaranteed rate is actually lower than the rate currently being paid on an account, the disclosure statement may use the higher rate, but must clearly indicate that the guaranteed rate is lower.[1]

For the reporting requirements imposed on IRA trustees with respect to required minimum distributions, see Q 3647.

3607. What is the saver's credit and who can claim it?

The Saver's Credit (formally known as the Retirement Savings Contributions Credit) permits certain lower-income taxpayers to claim a nonrefundable credit for qualified retirement savings contributions.[2] Qualified retirement savings contributions include contributions to Roth or traditional IRAs, as well as elective deferrals to a 401(k) plan (Q 3697), an IRC Section 403(b) tax sheltered annuity (Q 3909), an eligible Section 457 governmental plan (Q 3568), a SIMPLE IRA (Q 3654), and a salary reduction SEP (Q 3653). Voluntary after-tax contributions to a qualified plan or Section 403(b) tax sheltered annuity are also eligible for the credit.[3] The fact that contributions are made pursuant to a negative election (i.e., automatic enrollment) will not preclude a participant from claiming the saver's credit.[4] Contributions made to an IRA that are withdrawn, together with the net income attributable to such contribution, on or before the due date (including extensions of time) for filing the federal income tax return of the contributing individual are not considered eligible contributions.[5]

To prevent churning (simply switching existing retirement funds from one account to another to qualify for the credit), the total of qualified retirement savings contributions is reduced by certain distributions received by the taxpayer during the prior two taxable years and the current taxable year for which the credit is claimed, including the period up to the due date (plus extensions) for filing the federal income tax return for the current taxable year. Distributions received by the taxpayer's spouse during the same time period are also counted if the taxpayer and spouse filed jointly both for the year during which a distribution was made and the year for which the credit is taken.[6]

Corrective distributions of excess contributions and excess aggregate contributions (Q 3733), excess deferrals (Q 3705), dividends paid on employer securities under Section 404(k) (Q 3746), and loans treated as distributions (Q 3848) are not taken into account.[7]

To be eligible to claim the credit, the taxpayer must be at least 18 as of the end of the tax year and must not be claimed as a dependent by someone else or be a full-time student. Full-time students include any individual who is enrolled in school during some part of each of five months during the year and is enrolled for the number of hours or courses the school considers to be full-time.[8]

1. Rev. Rul. 86-78, 1986-1 CB 208.
2. IRC Sec. 25B.
3. IRC Sec. 25B(d)(1); Ann. 2001-106, 2001-44 IRB 416, A-5.
4. See Ann. 2001-106, 2001-44 IRB 416.
5. See Ann. 2001-106, 2001-44 IRB 416, A-5.
6. See Ann. 2001-106 Q-4.
7. IRC Sec. 25B(d)(2); Ann. 2001-106, above, A-4.
8. IRC Sec. 25B(c); Ann. 2001-106, 2001-44 IRB 416, A-2.

The amount of the credit is limited to an applicable percentage of IRA contributions and elective deferrals up to $2,000. The applicable percentages for 2014 are as follows:[1]

Adjusted Gross Income

Joint return		*Head of a household*		*All other cases*		*Applicable*
Over	*Not over*	*Over*	*Not over*	*Over*	*Not over*	*Percentage*
0	$36,000	0	$27,000	0	$18,000	50%
36,000	39,000	27,000	29,250	18,000	19,500	20%
39,000	60,000	29,250	45,000	19,500	30,000	10%
60,000		45,000		30,000		0%

The income limits are indexed for inflation.[2] For 2013, the maximum AGI for joint returns was $59,000, $44,250 for heads of households, and $29,500 for all others.[3] For this purpose, adjusted gross income is calculated without regard to the exclusions for income derived from certain foreign sources or sources within United States possessions.[4]

Taxpayers have until April 15, 2015, to contribute to traditional and Roth IRAs and still claim the credit on their 2014 tax returns.

For married taxpayers filing jointly, contributions by or for either or both spouses, up to $2,000 per year for each spouse, may give rise to the saver's credit.[5]

3608. When are funds in an IRA taxed?

Funds accumulated in a traditional IRA generally are not taxable until they are distributed (Q 3625). Funds accumulated in a Roth IRA may or may not be taxable on distribution (Q 3626). Special rules may treat funds accumulated in an IRA as a "deemed distribution" and, thus, includable in income under the rules discussed in Q 3625 for traditional IRAs and in Q 3626 for Roth IRAs.

A distribution of a nontransferable, nonforfeitable annuity contract that provides for payments to begin by age 70½ and not to extend beyond certain limits is not taxable, but payments made under such an annuity would be includable in income under the appropriate rules.

A contribution (excess or otherwise) may be distributed income tax-free under the rules discussed in Q 3623 (provided, in the case of a traditional IRA, that no deduction was allowed for the contribution). If net income allocable to the contribution is distributed before the due date for filing the tax return for the year in which the contribution was made, it must be included in income for the tax year for which the contribution was made even if the distribution actually

1. IR 2013-86.
2. IRC Sec. 25B(b)(3).
3. IR 2012-77.
4. IRC Sec. 25B(e).
5. Ann. 2001-106, 2001-44 IRB 416, A-9.

was made after the end of that year.[1] With respect to distributions of excess contributions after this deadline, the net income amount is included in income in the year distributed. Any net income amount also may be subject to penalty tax as an early distribution.

An individual may transfer, without tax, the individual's IRA to his or her spouse or former spouse under a divorce or separate maintenance decree or a written instrument incident to the divorce. The IRA then is maintained for the benefit of the former spouse.[2] Any other assignment of an IRA is a deemed distribution of the amount assigned.[3]

Where an individual rolled over his interest in a tax sheltered annuity to an IRA, pursuant to a QDRO (Q 3816), the subsequent transfer of the IRA to the individual's spouse was considered a "transfer incident to a divorce" and, thus, nontaxable to either spouse.[4]

A taxpayer was liable for taxes on a distribution from his IRA that he subsequently turned over to his ex-wife in satisfaction of a family court order because it was not a "transfer incident to divorce" and the family court order was not a QDRO because it did not specifically require the transfer of assets to come from the IRA.[5] A transfer of funds between the IRAs of a husband and wife that does not come within the divorce exception is a deemed distribution despite IRC provisions that provide that no gain is recognized on transfers between spouses.[6]

The transfer of a portion of a husband's IRA to his wife to be placed in an IRA for her benefit that was the result of a private written agreement between the two that was not considered incident to a divorce was not eligible for nontaxable treatment under IRC Section 408(d)(6).[7]

Where a taxpayer received a full distribution from his IRA and endorsed the distribution check over to his soon-to-be-ex-wife, the husband was determined to have failed to satisfy the requirements for a non-taxable transfer incident to divorce and was liable for taxation on the entire proceeds of the IRA distribution.[8]

Where two traditional IRAs were classified as community property, the distributions of the deceased spouse's community interest in the IRAs to relatives other than her surviving husband were taxable only to those recipients and not to the husband.

State community property laws, although disregarded for some purposes (Q 3611, Q 3612), are not preempted by IRC Section 408(g).[9] In a case of first impression, the Tax Court ruled that the recognition of community property interests in IRAs would conflict with existing federal tax rules. IRC Section 408(g) requires application without regard to community property laws. By reason of IRC Section 408(g), the former spouse is not treated as a distributee on any portion

1. IRC Sec. 408(d)(4); Treas. Reg. §1.408-4(c).
2. IRC Sec. 408(d)(6).
3. Treas. Reg. §1.408-4(a)(2).
4. Let. Rul. 8916083.
5. *Czepiel v. Comm.*, TC Memo 1999-289.
6. See Let. Ruls. 9422060, 8820086.
7. Let. Rul. 9344027.
8. *Jones v. Comm.*, TC Memo 2000-219.
9. Let. Rul. 8040101.

of the IRA distribution for purposes of federal income tax rules despite the former spouse's community property interest in the assets. Therefore, a distribution from an IRA to a former spouse is taxable to the account holder unless it is executed pursuant to decree of divorce, or other written maintenance decree under IRC Section 408(d)(6).[1]

Where taxpayers requested that an IRA be reclassified under state marital property law from individual property to marital property, no distribution under IRC Section 408(d)(1) was deemed to have occurred.[2]

The involuntary garnishment of a husband's IRA and resulting transfer of such funds to the former spouse to satisfy arrearages in child support payments was a deemed distribution to the husband because it discharged a legal obligation owed by the husband.[3]

Where a taxpayer transferred funds from a single IRA into two newly-created IRAs, the direct trustee-to-trustee transfers were not considered distributions under IRC Section 408(d)(1).[4] The division of a decedent's IRA into separate subaccounts does not result in current taxation of the IRA beneficiaries.[5]

If any assets of an individual retirement account are used to purchase collectibles (works of art, gems, antiques, metals, etc.), the amount so used will be treated as distributed from the account (and also may be subject to penalty as an early distribution). A plan may invest in certain gold or silver coins issued by the United States, any coins issued under the laws of a state, and certain platinum coins. A plan may buy gold, silver, platinum, and palladium bullion of a fineness sufficient for the commodities market if the bullion remains in the physical possession of the IRA trustee.[6] A plan may purchase shares in a grantor trust holding such bullion.[7]

If any part of an individual retirement account is used by the individual as security for a loan, that portion is deemed distributed on the first day of the tax year in which the loan was made.[8] Amounts rolled over into an IRA from a qualified plan by one of the twenty-five highest paid employees, however, may be pledged as security for repayments that may have to be made to the plan in the event of an early plan termination.[9] A less-than-sixty-day interest-free loan from IRA accumulations is possible under the rollover rules (Q 3895).[10]

If the owner of an individual retirement annuity borrows money under or by use of the contract in any tax year, including a policy loan, the annuity ceases to qualify as an individual retirement annuity as of the first day of the tax year and the fair market value of the contract would be deemed distributed on that day.[11]

1. *Bunney v. Comm.*, 114 TC 259 (2000).
2. Let. Ruls. 199937055, 9419036.
3. *Vorwald v. Comm.*, TC Memo 1997-15.
4. Let. Rul. 9438019. See also Rev. Rul. 78-406, 1978-2 CB 157; Let. Rul. 9433032.
5. Let. Rul. 200008044.
6. IRC Sec. 408(m); Let. Rul. 200217059.
7. Let. Ruls. 200732026, 200732027.
8. IRC Sec. 408(e)(4); Treas. Reg. §1.408-4(d)(2); Let. Ruls. 8335117, 8019103, 8011116.
9. See, e.g., Let. Ruls. 8845060, 8803087, 8751049. See also Treas. Reg. §1.401-4(c).
10. See Let. Rul. 9010007.
11. See IRC Sec. 408(e)(3). See also *Griswold v. Comm.*, 85 TC 869 (1985).

If an individual engages in a prohibited transaction during a year, his or her individual retirement account ceases to qualify as such as of the first day of that tax year; the individual is not liable for a prohibited transaction tax.[1] The fair market value of all the assets in the account is deemed distributed on that day.[2] If the account is maintained by an employer, only the separate account of the individual involved is disqualified and deemed distributed.[3]

The transfer to an individual retirement account of a personal note received in a terminating distribution from a qualified plan and the holding of that note is a prohibited transaction.[4]

The use of IRA funds to invest in a personal retirement residence of the taxpayer is considered a prohibited transaction under IRC Section 4975(c)(1)(D) and, thus, is treated as a distribution.[5]

Whether a purchase of life insurance in conjunction with an individual retirement plan but with non-plan funds constitutes a prohibited transaction apparently depends on the circumstances. The IRS has held that the purchase of insurance on the depositor's life by the trustee of the account with non-plan funds amounted to an indirect prohibited transaction by the depositor.[6] The IRS also has ruled that the solicitation by an association of individuals who maintain individual retirement plans with the association for enrollment in a group life plan did not result in a prohibited transaction where premiums would be paid by the individuals and not out of plan funds.[7]

Institutions may offer limited financial incentives to IRA and Keogh holders without running afoul of the prohibited transaction rules provided certain conditions are met. Generally speaking, the value of the incentive must not exceed $10 for deposits of less than $5,000 and $20 for deposits of $5,000 or more. These requirements also are applicable to SEPs that allow participants to transfer their SEP balances to IRAs sponsored by other financial institutions and to SIMPLE IRAs.[8]

A distribution of any amount may be received free of federal income tax to the extent the amount is contributed within sixty days to another plan under the rollover rules (Q 3891).

Distributions from traditional and Roth IRAs are not subject to the 3.8 percent Medicare contribution tax imposed under the Affordable Care Act. The tax equals 3.8 percent of the lesser of a taxpayer's net investment income for the taxable year, or the excess (if any) of the taxpayer's modified adjusted gross income for the year, over a threshold amount ($200,000 for a taxpayer filing an individual return and $250,000 for a taxpayer filing jointly). Internal Revenue Code Section 1411 specifically excludes distributions from IRAs and other qualified plans from the definition of "net investment income."

For the penalty tax imposed on accumulated amounts not distributed in accordance with the required minimum distribution rules, see Q 3634.

1. IRC Sec. 4975(c)(3).
2. See Treas. Reg. §1.408-1(c)(2).
3. IRC Sec. 408(e)(2).
4. TAM 8849001.
5. *Harris v. Comm.*, TC Memo 1994-22.
6. Let. Rul. 8245075.
7. Let. Rul. 8338141.
8. PTE 93-1, 58 Fed. Reg. 3567, 1-11-93; PTE 93-33, 58 Fed. Reg. 31053, 5-28-93, as amended at 64 Fed. Reg. 11044 (Mar. 8, 1999).

3609. How are earnings on an IRA taxed?

An IRA offers tax-free build up on contributions. The earnings on a traditional IRA are tax deferred to the owner; that is, they are not taxed until the owner begins receiving distributions (Q 3625). The earnings on a Roth IRA may or may not be taxed upon distribution (Q 3626). Like a trust that is part of a qualified plan, an individual retirement account is subject to taxes for its unrelated business income (Q 3869, Q 3970).

Tax deferral is lost if an individual engages in a prohibited transaction or borrows under or by use of an individual retirement annuity. The loss occurs as of the first day of the tax year in which the prohibited transaction or borrowing occurred.[1] For an account established by an employer or association of employees, only the separate account of the individual loses its deferred status.

3610. Are IRAs subject to attachment?

ERISA provides that benefits under "pension plans" must not be assigned or alienated.[2] This provision has been construed as protecting pension benefits from claims of creditors. ERISA defines a "pension plan" as a plan established or maintained by an employer to provide retirement income to employees. An individual retirement plan generally is not maintained by an employer and, thus, is not protected under federal law by ERISA's anti-alienation clause.[3]

Exclusions from bankruptcy are provided for qualified retirement plans, SEP IRAs, SIMPLE IRAs, and elective deferral Roths, but not for traditional IRAs and Roth IRAs.[4] In addition, exemptions from bankruptcy may be available for qualified retirement plans, SEP IRAs, SIMPLE IRAs, elective deferral Roths, traditional IRAs, and Roth IRAs. A debtor can choose to exempt property from the bankruptcy estate under either of two methods. Under the nonlist method, these exemptions are available if the debtor chooses not to list property that is exempt under federal, state, or local law.[5] Under the list method, these exemptions are available unless applicable state law does not so authorize.[6] (The U.S. Supreme Court has ruled that assets in a traditional IRA are eligible for the list exemption under Section 522(d)(10)(E) of the federal Bankruptcy Code).[7] Many states provide that the federal list exemptions are not available but instead provide their own state law exemptions in bankruptcy.

Planning Point: A debtor choosing between the list or nonlist methods should examine all of his or her assets, not just the IRA provisions, to determine which method would be more beneficial in bankruptcy. The debtor also should determine whether additional protection is provided by the law of the state (or states) that have jurisdiction over the debtor's assets.

The bankruptcy exemption for contributory (non-rollover) traditional and Roth IRAs is limited in the aggregate to $1 million (the amount is indexed every 3 years and the current

1. IRC Sec. 408(e); Treas. Reg. §1.408-1.
2. ERISA Sec. 206(d)(1).
3. *Patterson v. Shumate*, 504 U.S. 753 (1992).
4. 11 U.S.C. §§541(b)7), 541(c)(2).
5. 11 U.S.C. §522(b)(2).
6. 11 U.S.C. §§522(b)(1), 522(d)(10)(E), 522(d)(12).
7. *Rousey v. Jacoway*, 544 U.S. 320 (2005).

limit is, $1,245,475 per person), unless the bankruptcy court determines that "the interests of justice" require otherwise.[1] The exemption for IRA balances rolled over from other retirement accounts with an unlimited exemption is unlimited.

The exemption limit applies to the aggregate of all retirement accounts in combination, without regard to rollover contributions, and does not apply separately to each. Amounts in excess of the limit are subject to the claims of creditors.[2]

Planning Point: Although assets rolled over from non-Roth IRA retirement accounts, and future earnings on those assets, do not lose their unlimited exemption by virtue of a rollover, taxpayers with significant IRA balances are advised to keep their contributory and rollover IRA accounts segregated. Otherwise, to the extent that rollover IRA assets are commingled with contributory IRA assets, it may be difficult to calculate the value of the assets attributable to the rollover.

Outside the bankruptcy context, the U.S. Court of Appeals for the Seventh Circuit has ruled that because ERISA's anti-alienation provisions do not apply to assets contained in IRAs, such assets may be seized under criminal forfeiture proceedings brought by the federal government.[3] The Tenth Circuit Court of Appeals has held that an IRA trustee was not in breach of its fiduciary duty to an IRA account holder when the trustee responded to an IRS service of notice of levy for delinquent taxes owed by the account holder by turning over to the IRS assets held in the account.[4]

3611. Who may establish an IRA?

Virtually any individual who wishes to do so may establish a traditional individual retirement plan. To deduct contributions to such a plan once it is established and avoid tax penalties for excess contributions, an individual must have compensation (either earned income of an employee or self-employed person, or alimony), and must not have attained age 70½ during the taxable year for which the contribution is made.[5]

If an individual is an "active participant" (Q 3620), the deduction may be limited (Q 3614). Any individual who can make a rollover contribution (Q 3880) may establish an individual retirement plan (or more than one plan) to receive it (Q 3883 to Q 3895).[6]

To establish a Roth individual retirement plan, an individual (1) must have compensation (either earned income of an employee or self-employed person, or alimony), and (2) must not have adjusted gross income (in 2014) (a) of $191,000 or above in the case of a taxpayer filing a joint return, (b) of $129,000 or above in the case of a taxpayer filing a single or head-of-household return, or (c) of $10,000 or above in the case of a married individual filing separately (Appendix E).[7] An individual

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1. 11 U.S.C. §§104 and 522(n).
2. 11 U.S.C. §522(n).
3. *Infelise v. U.S.*, 159 F.3d 300 (7th Cir. 1998).
4. *Kane v. Capital Guardian Trust Co.*, 145 F.3d 1218 (10th Cir. 1998).
5. IRC Sec. 219.
6. Special Ruling 9-28-76.
7. IRS Pub. 590.

who satisfies these requirements may establish and contribute to a Roth IRA even if he or she has attained age 70½ (Q 3615).[1]

As to what constitutes "compensation," see Q 3619.

An estate may not make a contribution on behalf of the decedent.[2]

3612. May a person contribute to an IRA for a spouse?

A married individual may make contributions to a traditional individual retirement plan for a non-working spouse if (1) the non-working spouse and working spouse file a joint return for the taxable year, and (2) the amount of compensation (if any) includable in the non-working spouse's gross income for the taxable year is less than the compensation includable in the working spouse's gross income for the taxable year.[3] The deductibility of such contributions depends on whether the non-working spouse or working spouse is an "active participant" (Q 3620) and on the married couple's adjusted gross income (Q 3614).[4] Community property laws are disregarded for purposes of this deduction.[5]

A married individual may make contributions to a Roth individual retirement plan for a non-working spouse if (a) statements (1) and (2) above apply, and (b) the adjusted gross income of the married couple is less than the applicable limit (Q 3615).[6] As to what constitutes "compensation" for these purposes, see Q 3619. The joint return rule implicitly requires that, except where one or both have died, the contributing individual and the contributing individual's spouse have identical taxable years.[7]

An eligible individual may make contributions to a spousal plan even if the individual does not own or contribute to an individual retirement plan for himself or herself. Where plans are maintained for the contributing individual and his or her spouse, the plans may be separate plans or they may be sub-accounts of a single plan; a jointly-owned plan is not permitted. Nonetheless, each spouse may have a right of survivorship with respect to the sub-account of the other spouse.[8]

If the earner spouse dies during the taxable year, the non-working spouse may contribute to the spousal IRA if a joint return is filed for the year. No amount may be contributed to the IRA of a deceased spouse.[9]

The contributing individual must have been married to his or her spouse as of the last day of their tax year. An individual legally separated under a decree of divorce or separate maintenance is not married for these purposes.[10]

1. IRC Secs. 219, 408A; IR-2011-103, IR-2013-86.
2. Let. Rul. 8439066.
3. IRC Sec. 219(c)(2).
4. IRC Sec. 219(g).
5. IRC Sec. 219(f)(2).
6. IRC Secs. 219(c)(2), 408A(c)(3).
7. IRC Sec. 6013.
8. See General Explanation of the Tax Reform Act of 1976 *reprinted in* 1976-3 CB 442.
9. Let. Rul. 8527083.
10. IRC Sec. 6013(d)(2).

3613. When must contributions to IRAs be made?

A contribution made on account of the tax year of the contributing individual may be deducted in that year. Contributions to existing or new plans may be made and new plans may be established as late as the time when the individual's federal income tax return for the year is due (excluding extensions); with respect to traditional IRAs, contributions may be deducted for that tax year if the contribution is made on account of that year. This applies both to contributions to individual plans and contributions to spousal plans.[1] A postmark is evidence of the timeliness of the contribution.[2]

3614. How much may an individual contribute to a traditional IRA? How much may be deducted?

Contributions to traditional IRAs are limited at two levels. First, there is a limit on the amount of contributions that may be deducted for income tax purposes. Second, there is a limit with respect to the amount of total contributions that can be made, deductible and nondeductible.

Contributions to an individual retirement plan are not subject to the general limits on contributions and benefits of IRC Section 415 (Q 3784). (See Q 3650 for the effect of IRC Section 415 on simplified employee pensions). The source of the funds contributed to an IRA is not determinative as to eligibility or deductibility so long as the contributing individual has includable compensation at least equal to the amount of the contribution.[3]

Deductible Contributions

If an eligible individual contributes on his own behalf to a traditional IRA, he generally may deduct amounts contributed in cash up to the lesser of the "deductible amount" for the taxable year or 100 percent of *compensation* includable in his gross income for such year.[4]

The "deductible amount" is $5,500 for taxable years beginning in 2013 and 2014 (Appendix E).[5] This amount is indexed for inflation.

The "deductible amount" is increased by a $1,000 catch-up contribution for individuals who have attained age 50 before the close of the tax year.[6]

> *Example*: Danny, an unmarried college student working part-time, earns $4,500 in 2014. Danny can contribute up to $4,500, the amount of his compensation (rather than the deductible amount), to his IRA in 2014.

> *Example*: George, who is 34 years old and single, earns $24,000 in 2014. His IRA contributions for 2014 are limited to $5,500.

1. IRC Secs. 219(f)(3), 408A(c)(7).
2. Let. Ruls. 8633080, 8611090, 8536085.
3. See Let. Rul. 8326163.
4. IRC Sec. 219(b)(1).
5. IRC Sec. 219(b)(5)(A)); Notice 2013-73.
6. IRC Sec. 219(b)(5)(B).

Employer contributions to a simplified employee pension and any amounts contributed to a SIMPLE IRA are subject to different limitations.

Planning Point: Contributions cannot be made to a traditional IRA for the year in which the IRA participant reaches age 70½ or for any later year. A participant attains age 70½ on the date that is 6 calendar months after his/her 70th birthday. So, for example, if Matt were born on or before June 30, 1944, he cannot contribute to his IRA in 2014 or any later year.

The overall maximum contribution limit is also equal to the "deductible amount."[1] Contributions made to Roth IRAs for the taxable year reduce both deductible and overall contribution limits (Q 3615). As to what constitutes "compensation," see Q 3619.

In taxable years beginning in 2007 through 2009, the "deductible amount" was increased by $3,000 for former employees of bankrupt companies with indicted executives (e.g., Enron), if the employer matched 50 percent or more of employee 401(k) contributions in the form of employer stock. For taxpayers age 50 or older, the enhanced catch-up contribution was available instead of the usual $1,000 catch-up provision.[2]

If a married couple files a joint return, both spouses may contribute to an IRA even if only one spouse has taxable compensation. The maximum deduction allowed to an individual for a cash contribution to a traditional IRA *for a non-working spouse* for a taxable year is the lesser of (1) the "deductible amount" or (2) 100 percent of the non-working spouse's includable compensation, plus 100 percent of the working spouse's includable compensation minus (a) the amount of any IRA deduction taken by the working spouse for the year, and (b) the amount of any contribution made to a Roth IRA by the working spouse.[3]

> *Example*: Sarah, age 52, is married with no taxable compensation for 2014. She and her husband reported taxable compensation of $60,000 on their 2014 joint return. Sarah may contribute $6,500 to her IRA for 2014 ($5,500 plus an additional $1,000 contribution for age 50 and over).

While a husband and wife who file jointly are permitted a maximum deduction of up to $11,000 in 2014 ($13,000 with catch up contributions if they are both over 50), the deduction for each spouse is computed separately.

The deduction for contributions made to individual and spousal plans may be reduced or eliminated if the individual or his spouse is an "active participant" (Q 3620). The amount of the reduction is the amount that bears the same ratio to the overall limit as the taxpayer's *adjusted gross income* (AGI) in excess of an "applicable dollar amount" bears to $10,000 ($20,000 in the case of a joint return for taxable years beginning after 2006).[4] Applicable dollar amounts are indexed for inflation. Thus, the amount of the reduction is calculated as follows:

$$\text{“deductible amount”} \times \frac{\text{AGI} - \text{“applicable dollar amount”}}{\$10{,}000 \text{ (or } \$20{,}000) \text{ for joint return)}}$$

1. IRC Sec. 408(a)(1).
2. IRC Sec. 219(b)(5)(C).
3. IRC Sec. 219(c)(1).
4. IRC Sec. 219(g)(2).

In the case of a taxpayer who is an active participant and files a single or head-of-household return, the "applicable dollar amount" is $59,000 in 2013 and $60,000 in 2014 (Appendix E).[1]

In the case of married taxpayers who file a joint return, where one or both spouses are active participants, the "applicable dollar amount" for a spouse who is an active participant is $95,000 for 2013 and $96,000 for 2014 (Appendix E).[2]

In the case of married taxpayers who file a joint return, where only one is an active participant, the "applicable dollar amount" for the non-active participant spouse is $178,000 for 2013 and $181,000 for 2014 Appendix E). The denominator in the fraction remains at $10,000 (it does not increase to $20,000).[3]

In the case of a married individual filing a separate return where either spouse is an active participant, the "applicable dollar amount" is $0.[4]

Example: Jack and Jill are married and file a joint tax return for 2014. Jack is an active participant, but Jill is not. Their modified adjusted gross income is $105,000. Jack is under age 50 and is therefore able to contribute $5,500 to a Traditional IRA.

Using the formula above, Jack calculates his maximum deductible amount:

= $5,500 × ($105,000 – $95,000)/$20,000

= $2,750, which represents the amount of the reduction

= $5,500 (the maximum contribution amount) minus $2,750 (the reduction amount)

Answer = $2,750

Because Jill is the non-active participant with an active participant spouse, the "applicable dollar amount" for Jill is $178,000 for 2013, well above Jack and Jill's AGI. Accordingly, a $5,500 contribution to Jill's IRA is fully deductible.

Due to these "active participant" limitations, a deduction for contributions made to an IRA in 2014 will be eliminated for:

(1) individuals who are active participants and file a single or head-of-household return with AGI of $70,000 and above,

(2) married individuals who are active participants and file a joint return with AGI of $116,000 and above,

(3) married individuals where only one spouse is an active participant and file a joint return with AGI of $191,000 and above, and

(4) married individuals who are active participants *or* their spouses are active participants and file separately with AGI of $10,000 and above (Appendix E).

1. IRC Sec. 219(g)(3)(B)(ii); Notice 2013-73, IR-2013-86.
2. IRC Sec. 219(g)(3)(B)(i); Notice 2013-73, IR-2013-86.
3. IRC Sec. 219(g)(7)(B); Notice Notice 2013-73.
4. IRC Sec. 219(g)(3)(B)(iii).

The amount of the reduction is rounded to the next lowest multiple of $10[1]. Unless the individual's deduction limit is reduced to zero, the IRC permits a minimum deduction of $200.[2]

For this purpose, AGI is calculated without regard to the exclusions for foreign earned income, qualified adoption expenses paid by the employer and interest on qualified United States savings bonds used to pay higher education expenses. Social Security benefits includable in gross income under IRC Section 86 and losses or gains on passive investments under IRC Section 469 are taken into account. Also for this purpose, contributions to a traditional IRA are not deducted in determining AGI.[3]

The deduction is taken from gross income so that an individual who does not itemize his deductions may take advantage of the retirement savings deduction[4]. No deduction may be taken for a contribution *on behalf of* an individual who has attained age 70½ before the end of the tax year.[5] An individual over age 70½ may take a deduction for a contribution made on behalf of a spouse who is under age 70½. An excess contribution made in one year can be deducted in a subsequent year to the extent the excess is absorbed in the later year (Q 3623).

The cost of a disability waiver of premium feature in an individual retirement annuity is deductible under IRC Section 219, but where an individual contributes to an annuity for the benefit of himself and his non-employed spouse, the waiver of premium feature may only be allocated to the working spouse's interest.[6]

No deduction is allowed for contributions to an IRA if the individual for whose benefit the IRA is maintained acquired that IRA by reason of the death of another individual after 1983. But this does not apply where the acquiring individual is the surviving spouse of the deceased individual.[7]

For the limits on contributions to Roth IRAs, see Q 3615. For limits on contributions to simplified employee pensions, see Q 3650. For limits on contributions to a SIMPLE IRA, see Q 3654.

Nondeductible Contributions

Nondeductible contributions can also be made to a traditional IRA. The limit on nondeductible contributions is equal to the *excess of* the "deductible amount," discussed above, *over* the actual maximum deduction.[8] Contributions made to Roth IRAs for the taxable year reduce this limit (Q 3615). This limit is not reduced because an individual's AGI exceeds certain limits (in contrast, see Q 3615 with respect to contributions to Roth IRAs). A taxpayer may elect

1. IRC Sec. 219(g)(2)(C).
2. IRC Sec. 219(g)(2)(B).
3. IRC Sec. 219(g)(3)(A); See Treas. Reg. §1.408A-3, A-5.
4. IRC Sec. 62(a)(7).
5. IRC Sec. 219(d)(1).
6. Let. Rul. 7851087.
7. IRC Secs. 219(d)(4), 408(d)(3)(C)(ii).
8. IRC Sec. 408(o)(2)(B)(i).

to treat contributions that would otherwise be deductible as nondeductible[1]. Nondeductible contributions must be reported on the individual's tax return and penalties apply if the required form is not filed or the amount of such contributions is overstated (Q 3648).

Planning Point: It is generally better to make nondeductible contributions to a Roth IRA (Q 3615) rather than nondeductible contributions to a traditional IRA.

Endowment Contracts

Endowment contracts issued after November 6, 1978 do not qualify as individual retirement annuities; therefore, contributions to such contracts are not deductible.[2] Furthermore, in the case of contributions to an endowment contract individual retirement annuity issued before November 7, 1978, no deduction is allowed for contributions that are allocable to the purchase of life insurance protection. The amount allocable to life insurance protection is determined by multiplying the death benefit payable during the tax year less the cash value at the end of the year by the net premium cost. (See Q 540 for purposes of valuing the economic benefit of current life insurance protection). The nondeductible amount may be contributed to another funding medium and a deduction taken so that the maximum deduction may be used, but it may not be used to pay the premium for an annuity if the total premium on behalf of any one individual would then exceed the maximum annual contribution limit.

3615. How much may an individual contribute to a Roth IRA?

An eligible individual may contribute cash to a Roth IRA on his own behalf up to the *lesser of* the maximum annual contribution limit (equal to the "deductible amount" under IRC Section 219(b)(5)(A)) or 100 percent of *compensation* includable in his gross income for the taxable year. The amount that can be contributed, however, is *reduced by* any contributions made to traditional IRAs for the taxable year on his own behalf.[3]

The maximum annual contribution limit is $5,500 in 2013 and 2014 (Appendix E). This amount is indexed for inflation. The maximum annual contribution limit is increased by $1,000 for individuals who have attained age 50 before the close of the tax year (Appendix E).[4]

SEPs and SIMPLE IRAs may not be designated as Roth IRAs, and contributions to a SEP or SIMPLE IRA will not affect the amount that an individual can contribute to a Roth IRA.[5] Qualified rollover contributions (Q 3617) do not count towards this limit.[6] As to what constitutes "compensation," see Q 3619. Roth IRA contributions are not deductible and can be made even after the individual turns age 70½.[7]

In taxable years beginning in 2007 through 2009, the maximum annual contribution limit was increased by $3,000 for former employees of bankrupt companies with indicted executives

1. IRC Sec. 408(o)(2)(B)(ii).
2. See Treas. Regs. §§1.408-4(f), 1.408-3(e)(1)(ix).
3. IRC Sec. 408A(c)(2).
4. IRC Sec. 219(b)(5); Notice 2013-73.
5. IRC Sec. 408A(f).
6. IRC Sec. 408A(c)(6).
7. IRC Secs. 408A(c)(1), 408A(c)(4).

(e.g., Enron), if the employer matched 50 percent or more of employee 401(k) contributions in the form of employer stock. For taxpayers age 50 or older, the enhanced catch-up contribution was available instead of the usual $1,000 catch-up provision.[1]

An individual may contribute cash to a Roth IRA *for a non-working spouse* for a taxable year up to the maximum deductible limit (disregarding active participant restrictions) permitted with respect to traditional IRAs for such non-working spouse (Q 3614), reduced by any such contributions made to traditional IRAs for the taxable year on behalf of the non-working spouse.[2] Thus, a married couple (both spouses under age 50) may be permitted a maximum contribution of up to $10,000 for 2011 and 2012 ($5,000 for each spouse) and $11,000 in 2013 and 2014.

The maximum contribution permitted to an individual Roth IRA or a spousal Roth IRA is reduced or eliminated for certain high-income taxpayers. The amount of the reduction is the amount that bears the same ratio to the overall limit as the taxpayer's *adjusted gross income* (AGI) in excess of an "applicable dollar amount" bears to $15,000 ($10,000 in the case of a joint return).[3]. Thus, the amount of the reduction is calculated as follows:

$$\text{maximum contribution} \times \frac{\text{AGI} - \text{“applicable dollar amount”}}{\$15{,}000\ (\$10{,}000 \text{ if a joint return})}$$

The "applicable dollar amount" in 2014 is (1) $114,000 in the case of an individual ($112,000 for 2013), (2) $181,000 ($178,000 in 2013) in the case of a married couple filing a joint return, and (3) $0 in the case of a married person filing separately.[4] (Appendix E).

Thus in 2014, the Roth IRA contribution limit is $0 for (1) individuals with AGI of $129,000 and above ($127,000 in 2013), (2) married couples filing a joint return with AGI of $191,000 and above ($188,000 in 2013), and (3) a married individual filing separately with AGI of $10,000 and above (Appendix E). Except for married individuals filing separately, the "applicable dollar amount" is indexed for inflation. The amount of the reduction is rounded to the next lowest multiple of $10. Unless the individual's contribution limit is reduced to zero, the IRC permits a minimum contribution of $200.[5]

For this purpose, AGI is calculated without regard to the exclusions for foreign earned income, qualified adoption expenses paid by the employer, and interest on qualified United States savings bonds used to pay higher education expenses. Social Security benefits includable in gross income under IRC Section 86 and losses or gains on passive investments under IRC Section 469 are taken into account. Also for this purpose, deductible contributions to a traditional IRA plan are not taken into account in determining AGI; amounts included in gross income as a result of a rollover or conversion from a traditional IRA to a Roth IRA are not taken into account for purposes of determining the maximum contribution limit for a Roth IRA.

1. IRC Sec. 219(b)(5)(C).
2. See IRC Secs. 408A(c)(2), 219(b)(1), 219(c).
3. IRC Sec. 408A(c)(3).
4. Notice 2013-73; IR-2013-86.
5. IRC Sec. 408A(c)(3)(A).

3616. Can a taxpayer whose income level exceeds the limitations for Roth IRA contributions maintain a Roth IRA?

Yes. Despite the fact that a taxpayer whose income level exceeds the Roth IRA contribution limits cannot contribute directly to a Roth IRA, he or she is permitted to maintain a Roth account. In 2014, the ability to make contributions to a Roth IRA begins to phase out for married taxpayers with income over $181,000 ($114,000 for single taxpayers). Roth contributions are completely blocked for married taxpayers who earn over $191,000 and single taxpayers who earn over $129,000.[1]

While contributions cannot be made directly to the Roth if the taxpayer's income exceeds the annual income threshold, for tax years beginning in 2010 and after, the income limits that applied to prevent high-income taxpayers from making rollovers from traditional IRAs were eliminated.[2]

Therefore, many high-income taxpayers may make contributions indirectly to a Roth account, via a series of rollovers from traditional IRAs. The taxpayer must first open a traditional IRA if the taxpayer does not already maintain such an account (in 2014, each taxpayer can contribute up to $5,500 to an IRA ($6,500 if the taxpayer is 50 or older).[3] The taxpayer can then roll a portion of the IRA into a Roth account each year, though taxes must be paid on the amounts that are rolled over.

3617. Can an individual roll over or convert a traditional IRA or other eligible retirement plan into a Roth IRA?

Yes.

A "qualified rollover contribution" can be made from a traditional IRA or any eligible retirement plan (Q 3883) to a Roth IRA.[4] A rollover was not permitted prior to 2010 if a taxpayer had adjusted gross income ("AGI") of more than $100,000 for the taxable year of the distribution to which the rollover related or if the taxpayer was a married individual filing a separate return.[5]

Amounts that are held in a SEP or a SIMPLE IRA that have been held in the account for two or more years also may be converted to a Roth IRA.[6]

The taxpayer must include in income the amount of the distribution from the traditional IRA or other eligible retirement plan that would be includable if the distribution were not rolled over.[7] (See Q 3625 for taxation of amounts distributed from such IRAs). Thus, if only deductible contributions were made to an eligible retirement plan, the entire amount of the distribution would be includable in income in the year rolled over or converted. (Special rules apply

1. IR-2013-86 (Oct. 31, 2013).
2. IRC Secs. 408A(c)(3)(B), 408A(e).
3. IR-2013-86 (Oct. 31, 2013).
4. IRC 408A(e).
5. Treas. Reg. §1.408A-4, A-2.
6. Treas. Reg. §1.408A-4, A-4.
7. IRC Secs. 408A(d)(3)(A)(i), 408A(d)(3)(C).

for conversions made in 2010). While the 10 percent early distribution penalty (Q 3629) does not apply at the time of the conversion to a Roth IRA, it does apply to any converted amounts distributed during the five year period beginning with the year of the conversion.[1]

Planning Point: Anybody could make a Roth IRA conversion for 2010. Income from a conversion in 2010 could be recognized one-half in 2011 and one-half in 2012, rather than all in 2010.

When an individual retirement annuity is converted to a Roth IRA, or when an individual retirement account that holds an annuity contract as an asset is converted to a Roth IRA, the amount that is deemed distributed is the fair market value of the annuity contract on the date of the (deemed) distribution. If, in converting to a Roth IRA, an IRA annuity contract is completely surrendered for its cash value, regulations provide that the cash received will be the conversion amount.[2]

Non-rollover contributions made to a traditional IRA for a taxable year (and any earnings allocable thereto) may be transferred to a Roth IRA on or before the due date (excluding extensions of time) for filing the federal income tax return of the contributing individual and no such amount will be includable in income, providing no deduction was allowed with respect to such contributions.[3] Such contributions would be subject to the maximum annual contribution limits (Q 3615).

A "qualified rollover contribution" is any rollover contribution to a Roth IRA from a traditional IRA or other eligible retirement plan that meets the requirements of IRC Section 408(d)(3) (Q 3891). A rollover or conversion of a traditional IRA to a Roth IRA does not count in applying the one IRA-to-IRA rollover in any twelve month period limit (Q 3891).[4]

For years prior to 2010, the taxpayer's AGI was calculated without regard to the exclusions for foreign earned income, qualified adoption expenses paid by the employer, and interest on qualified United States savings bonds used to pay higher education expenses. Deductible contributions to a traditional IRA also were not taken into account in determining AGI. Amounts included in gross income as a result of a rollover or conversion from a traditional IRA or other eligible retirement plan to a Roth IRA were not taken into account.[5] Social Security benefits includable in gross income under IRC Section 86 and losses or gains on passive investments under IRC Section 469 were taken into account. The definition of AGI excludes minimum required distributions to IRA owners aged 70½ or older, solely for purposes of determining eligibility to convert a regular IRA to a Roth IRA.[6]

An eligible retirement plan, for this purpose, includes a qualified retirement plan, an IRC Section 403(b) tax sheltered annuity, or an eligible IRC Section 457 governmental plan. Taxpayers, including plan beneficiaries, can directly transfer (and thereby convert) money from these

1. IRC Sec. 408A(d)(3)(F).
2. Treas. Reg. § 1.408A-4.
3. IRC Sec. 408(o)(3) and 408A(c)(7).
4. IRC Sec. 408A(e).
5. IRC Sec. 408A(c)(3)(B)(i).
6. IRC Sec. 408A(c)(3)(B)(i).

plans into a Roth IRA without the need for a conduit traditional IRA (as was required prior to 2008).[1] (Other than by direct conversion from an eligible non-IRA retirement plan, a beneficiary may not convert to a Roth IRA.)[2]

Unless a taxpayer elects otherwise, income from conversions to Roth IRAs occurring in 2010 were to be reported ratably in 2011 and 2012.[3]

Qualified rollover contributions do not count toward the annual maximum contribution limit applicable to Roth IRAs (Q 3615).[4]

A rollover from a Roth IRA or a designated Roth account to a Roth IRA is not subject to the adjusted gross income limitation and is not subject to tax.[5]

Planning Point: Major reasons for converting to a Roth IRA often include obtaining tax-free qualified distributions from the Roth IRA and greater stretch from the Roth IRA because distributions from a Roth IRA are not required until after the death of the owner (or the death of the IRA owner's spouse if the spouse is the sole designated beneficiary and elects to treat the IRA as the spouse's own), rather than starting at age 70½. A conversion also may make sense if it is expected that tax rates will increase (from the time of conversion to the time of distribution), but not if tax rates will decrease. Consider whether any special tax benefits, such as net unrealized appreciation, would be lost if a qualified plan is converted to a Roth IRA. Also, a qualified plan may offer better asset protection than a Roth IRA. State laws vary on this issue. If a taxpayer cannot qualify under the Roth AGI limitations, perhaps he or she can establish a traditional IRA, and then convert that into a Roth IRA. Note that this, however, has not yet been addressed by the IRS.

3618. Can an individual correct a Roth conversion? What is a recharacterization?

If a taxpayer has rolled over funds from a traditional IRA or other eligible retirement plan to a Roth IRA during the taxable year, and later discovers that his or her AGI is in excess of $100,000 in a year before 2010 (or for any other reason wants the transaction undone), the taxpayer generally has until the due date for filing his or her return (including extensions) to correct such a conversion without penalty, to the extent all earnings and income allocable to the conversion are also transferred back to the original IRA, and no deduction had been allowed with respect to the original conversion.[6] This "recharacterization" in the form of a trustee-to-trustee transfer results in the recharacterized contribution being treated as a contribution made to the transferee IRA, instead of to the transferor IRA.[7] A taxpayer can apply to the IRS for relief from the time limit for making a recharacterization.[8]

For purposes of a recharacterized contribution, the net income attributable to a contribution made to an IRA is determined by allocating to the contribution a pro-rata portion of the

1. IRC Sec. 408A(d)(3); Notice 2008-30, 2008-1 CB 638, A-7.
2. IRC 402(c)(11).
3. IRC Sec. 408A(d)(3)(A)(iii).
4. IRC Sec. 408A(c)(6)(B).
5. IRC Secs. 408A(c)(3)(B); 408A(d)(3)(B).
6. IRC Sec. 408A(d)(6); Notice 2008-30, 2008-1 CB 638, A-5.
7. See Treas. Reg. §1.408A-5.
8. See Let. Ruls. 200234073, 200213030.

earnings or losses accrued by the IRA during the period the IRA held the contribution. This allows the taxpayer to claim any net income that is a negative amount.[1]

A time restriction is placed on reconversions (i.e., converting to a Roth IRA a second time after recharacterizing a first conversion). A person can reconvert back to a Roth IRA but only after the later of the beginning of the next year or thirty days after the recharacterization.[2]

Planning Point: Where the value of converted property drops after a conversion to a Roth IRA, it may be useful to recharacterize the contribution back to the other type of IRA and then reconvert to a Roth IRA to reduce the amount taxable on converting to a Roth IRA. The time restriction on reconversions reduces, but does not eliminate, the potential value of this technique.

Reconversions and recharacterizations must be reported to IRS on Form 1099-R and Form 5498. Prior year recharacterizations must be reported under separate codes. All recharacterized contributions received by an IRA in the same year are permitted to be totaled and reported on a single Form 5498.[3]

3619. What is "compensation" for purposes of IRA eligibility rules and deduction limits?

For purposes of the eligibility rules and deduction limits applicable to Traditional and Roth IRAs, "compensation" means wages, salary, professional fees, or other amounts derived from, or received for, personal services actually rendered. "Compensation" also includes alimony paid under a divorce or separation agreement that is includable in the income of the recipient under IRC Section 71.[4]

In the case of a self-employed individual, "compensation" includes earned income from personal services, but in computing the maximum IRA or SEP contribution, such income must be reduced by (1) any qualified retirement plan contributions made by such individual on his or her own behalf and (2) the 50 percent of self-employment taxes deductible by the individual.

Earned income not subject to self-employment tax because of an individual's religious beliefs is "compensation."[5]

An individual whose income for the tax year consists solely of interest, dividend, and pension income has no "compensation" and cannot deduct any portion of a traditional IRA contribution.[6] In addition, such a person may not make a Roth IRA contribution.[7]

Compensation does not include earnings and profits from property, such as rental income, interest, and dividend income, or any amount received as pension or annuity income, or as deferred compensation (See IRS Tax Topics No. 451)

1. Treas. Reg. §1.408A-5; Notice 2000-39, 2000-2 CB 132.
2. Treas. Reg. §1.408A-5, A-9.
3. Notice 2000-30, 2000-1 CB 1266.
4. IRC Secs. 219(f)(1), 408A(a); Treas. Reg. §1.408A-3, A-4.
5. IRC Sec. 219(f)(1).
6. *King v. Comm.*, TC Memo 1996-231.
7. IRC Sec. 408A(c)(2).

Nor does "compensation" include any Social Security or railroad retirement benefits required to be included in gross income.[1] Payments made to employees terminated because of a restructuring of the company are deferred compensation and may not be used as a basis for IRA contributions.[2] Amounts received from an employer as deferred incentive awards, whether in the form of cash, stock options, or stock appreciation rights, also are not "compensation."[3] However, incentive pay awarded in one year for services performed in that year but paid in the following year is considered "compensation" in that second year[4].

The IRS has ruled that disability income payments, whether made under public or private plans, do not constitute "compensation."[5] Also, unemployment benefits do not constitute "compensation" because they are paid due to an inability to earn wages and not for personal services actually rendered.[6]

Additionally, the IRS has issued a compensation "safe harbor." The amount properly shown in the box for "wages, tips, other compensation," less any amount properly shown in the box for "nonqualified plans," on Form W-2 is considered compensation for purposes of calculating an individual's IRA contribution.[7]

Amounts paid by a husband to his wife to manage their jointly-owned investment property may not be treated by the wife, on a joint return, as compensation for purposes of an IRA contribution.[8] Similarly, wages paid to a wife by her spouse and deposited in their joint account are not considered compensation because deposit in a joint account does not constitute actual payment of wages to the wife.[9]

Payment in hogs rather than cash by a husband to his wife for her services in running their farm, however, was considered to be compensation for purposes of making an IRA contribution.[10]

A self-employed individual who shows a net loss for the tax year cannot take any IRA deduction.[11] A salaried employee who also is self-employed should disregard net losses from self-employment when computing his or her maximum deduction.[12]

3620. Who is an "active participant" for purposes of IRA eligibility rules and deduction limits?

Suppose an individual is an "active participant" in

(1) a qualified corporate or Keogh pension, profit sharing, stock bonus, or annuity plan,

1. IRC Secs. 86(f)(3), 219(f)(1); Treas. Reg. §1.219-1(c)(1).
2. Let. Ruls. 8534106, 8519051.
3. Let. Rul. 8304088.
4. Let. Rul. 8707051.
5. See Let. Ruls. 8331069, 8325080, 8014110.
6. *Russell v. Comm.*, TC Memo 1996-278.
7. See Rev. Proc. 91-18, 1991-1 CB 522.
8. Let. Rul. 8535001.
9. Let Rul. 8707004.
10. TAM 9202003.
11. *Est. of Hall v. Comm.*, TC Memo 1979-342.
12. Rev. Rul. 79-286, 1979-2 CB 121.

(2) a simplified employee pension or SIMPLE IRA,

(3) a Section 403(b) tax sheltered annuity, or

(4) a government plan.

In those instances, the individual's deduction limit for contributions to a traditional IRA may be reduced or eliminated (Q 3614). The limitation applies if the individual or the individual's spouse was an active participant for any part of the plan year that ended with or within the taxable year.[1]

Participation in Social Security, Railroad Retirement (tier I or II), or in an eligible IRC Section 457 deferred compensation plan (Q 3567) is not taken into consideration.[2] Federal judges are treated as active participants.[3] Active participants include any individual who is an active participant in a plan established for employees by the United States, a state or political subdivision thereof, or an agency or instrumentality of any of the foregoing.[4]

A district court judge in the state of Nebraska who participated in the Nebraska Retirement Fund for Judges was found to be an employee of the state (not an officer of the state) and, thus, was an active participant.[5]

Full-time active duty officers in the U.S. Air Force were found to be active participants.[6] Certain members of the armed forces reserves and certain volunteer firemen covered under government plans are not considered active participants.[7]

A teacher employed by a municipal school district in Michigan was found to be an active participant in the employment-based, qualified retirement plan provided by the state based upon his being an employee of a state or political subdivision through his employment in the school district.[8]

Active participant status for a tax year must be reported by the employer on the employee's Form W-2.

Active participant status is determined without regard to whether such individual's rights under the plan, trust, or contract are nonforfeitable.[9] Active participant status is further determined under the rules provided in Notice 87-16[10] and Treasury Regulation Section 1.219-2 (active participant rules in effect prior to the Economic Recovery Tax Act of 1981).

1. IRC Sec. 219(g)(1); see *Wartes v. Comm.*, TC Memo 1993-84.
2. IRC Sec. 219(g)(5); Notice 87-16, 1987-1 CB 446, A-7; Notice 89-25, 1989-1 CB 662; Notice 98-49, 1998-2 CB 365.
3. OBRA '87, Sec. 10103.
4. IRC Sec. 219(g)(5)(A)(iii).
5. *Fuhrman v. Comm.*, TC Memo 1997-34.
6. *Morales-Caban v. Comm.*, TC Memo 1993-466.
7. IRC Sec. 219(g)(6).
8. *Neumeister v. Comm.*, TC Memo 2000-41.
9. IRC Sec. 219(g)(5), flush language; see *Nicolai v. Comm.*, TC Memo 1997-108; *Wartes v. Comm.*, TC Memo 1993-84.
10. 1987-1 CB 446.

In the case of a defined benefit plan, an individual who is not excluded under the eligibility provisions of the plan for the plan year ending with or within the individual's taxable year is an active participant in the plan, regardless of whether such individual has elected to decline participation in the plan, has failed to make a mandatory contribution specified under the plan, or has failed to perform the minimum service required to accrue a benefit under the plan.[1] An individual in a plan under which accruals all have ceased is not an active participant. Where benefits may vary with future compensation, all accruals are not considered to have ceased.[2]

In the case of a profit sharing or stock bonus plan, an individual is an active participant if any employer contribution is deemed added or any forfeiture is allocated to the individual's account during the individual's taxable year.[3] A contribution is treated as made to an individual's account on the later of the date the contribution is made or allocated.[4]

If the right to an allocation is conditioned on the performance of a specified number of hours (or on the employment of the participant on a specified day) and the individual does not meet the condition for a particular year, the individual is not an active participant with respect to the taxable year within which such plan year ends.[5]

Where contributions to a plan are purely discretionary and no amount attributable to forfeitures or contributions has been allocated to an individual's account by the last day of the plan year, the individual is not an active participant for the taxable year in which the plan year ends. If the employer contributes an amount after the end of the plan year for that prior plan year, however, the individual generally is an active participant for the taxable year in which the contribution is made.[6]

An individual is an active participant in a money purchase pension plan if any contribution or forfeiture is required to be allocated to his or her account for the plan year ending with or within his or her taxable year, even if the individual was not employed at any time during the taxable year.[7]

An individual is an active participant for any taxable year in which the individual makes a voluntary or mandatory contribution.[8] The individual is not treated as an active participant if only earnings (rather than contributions or forfeitures) are allocated to his or her account.[9]

An individual is not considered an active participant in a plan integrated with Social Security if his or her compensation is less than the minimum needed to accrue a benefit or to be eligible for an allocation in the plan.[10]

1. Notice 87-16, 1987-1 CB 446, A-15; Treas. Reg. §1.219-2(b)(1); see *Nicolai v. Comm.*, TC Memo 1997-108.
2. Notice 87-16, 1987-1 CB 446, A-16; Treas. Reg. §1.219-2(b)(3); Let. Rul. 8948008.
3. Treas. Reg. §1.219-2(d)(1); see *Tolley v. Comm.*, TC Memo 1997-244.
4. Treas. Reg. §1.219-2(d)(1).
5. Notice 87-16, 1987-1 CB 446, A-20; Let. Rul. 8919064.
6. Notice 87-16, 1987-1 CB 446; Let. Rul. 9008056.
7. Treas. Reg. §1.219-2(c).
8. Treas. Reg. §1.219-2(e); see *Felber v. Comm.*, TC Memo 1992-418; *Wade v. Comm.*, TC Memo 2001-114.
9. Notice 87-16, 1987-1 CB 446, A-16, A-19.
10. Notice 87-16, 1987-1 CB 446, A-9.

There is no de minimis rule for active participant status. An individual may be an active participant even if no money is allocated to his or her account.[1] Active participant status is determined without regard to whether the individual is vested in any portion of his or her benefit.

3621. Are fees or commissions paid in connection with an IRA deductible?

The IRS has ruled that the payment of administrative or trustee fees incurred in connection with an individual retirement account may be claimed as a miscellaneous itemized deduction (i.e., for the production or collection of income) if such fees are separately billed and paid.[2] Furthermore, if separately billed and paid, the payment of such fees does not constitute a contribution to the individual retirement account and thus will not be an excess contribution or reduce the amount that may be contributed to the account or, in the case of a traditional IRA, deducted (Q 3614).[3] Deduction of administrative fees is subject to the 2 percent floor on miscellaneous itemized deductions.

Sales commissions on individual retirement annuities that are billed directly by an insurance agent to the client and paid separately by the client are not separately deductible, but are subject to the overall limits on contributions and deductions.[4]

Similarly, broker's commissions incurred in connection with the purchase of securities on behalf of an IRA are not separately deductible, but are subject to the overall limits.[5]

An annual maintenance fee charged for self-directed brokerage accounts that did not vary with the number of transactions, the number of securities involved, or the dollar amount and that was paid to the trustee, not the broker, was not treated as a commission but was separately deductible as an administrative fee.[6]

In addition, brokerage account "wrap fees" that were based on a percentage of assets under management, but that did not vary based on the number of trades in the account, were not treated as a commission and were separately deductible as an administrative fee.[7]

The IRS has held that the payment of fees associated with flexible premium variable annuity contracts that are paid directly from subaccounts within the contract would not be considered a distribution from the contract.

The IRS ruled that assessing expenses against the contract is unrelated to whether or not the participant is currently entitled to benefits under the contract. Therefore, such payments are an expense of the contract and not a distribution.[8]

1. *Colombell v. Comm.*, TC Summ. Op. 2006-184.
2. Rev. Rul. 84-146, 1984-2 CB 61; Let. Ruls. 9005010, 8951010.
3. See Let. Ruls. 8432109, 8329058, 8329055, 8329049.
4. Let. Rul. 8747072.
5. Rev. Rul. 86-142, 1986-2 CB 60; Let. Rul. 8711095.
6. Let. Rul. 8835062.
7. Let. Rul. 200507021.
8. Let. Rul. 9845003.

3622. Is interest paid on amounts borrowed to fund an IRA deductible?

The IRS has ruled that interest paid on amounts borrowed to fund an IRA is not allocable to tax-exempt income (Q 3609). Therefore, the deduction of such interest is not subject to the general prohibition against deducting interest incurred or carried to purchase tax-exempts.[1] Because such interest is "on amounts borrowed to buy or carry property held for investment," it would seem that it should be classified as "investment interest expense" and the deduction limited.

Interest paid on money borrowed to buy property held for investment is investment interest. Such interest is deductible but generally limited to the taxpayer's net investment income for the year.[2] However, interest incurred to produce tax-exempt income is not deductible.

Property held for investment includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. It also includes property that produces gain or loss (not derived in the ordinary course of a trade or business) from the sale or trade of property producing these types of income or held for investment (other than an interest in a passive activity). Investment property also includes an interest in a trade or business activity in which you did not materially participate (other than a passive activity).[3]

3623. What is the penalty for making excessive contributions to an IRA?

If contributions are made in excess of the maximum contribution limit for traditional IRAs (Q 3614) or for Roth IRAs (Q 3615), the contributing individual is liable for a nondeductible excise tax of 6 percent of the amount of the excess for every year the excess contribution remains in the IRA (not to exceed 6 percent of the value of the account or annuity, determined as of the close of the tax year).[4] A contribution by a person ineligible to make the contribution is an excess contribution even if it is made through inadvertence.[5]

In the case of an endowment contract described in IRC Section 408(b), the tax does not apply to amounts allocable to life, health, accident, or other insurance.[6] It also does not apply to premiums waived under a disability waiver of premium feature in an individual retirement annuity.[7]

The penalty tax does not apply to "rollover" contributions to a traditional IRA or "qualified rollover contributions" to a Roth IRA.[8] It does apply, however, if the "rollover" contribution does not qualify for rollover. The Tax Court did not accept the argument that an IRA created in a failed rollover attempt is not a valid IRA and, thus, the 6 percent penalty should not apply.[9] Likewise, a failed Roth IRA conversion that is not recharacterized is subject to the 6 percent penalty.[10]

1. Let. Rul. 8527082. See IRC Secs. 163(a), 265.
2. IRC Sec 163(d).
3. IRS Publication 550 (2011).
4. IRC Sec. 4973(a).
5. *Orzechowski v. Comm.*, 69 TC 750 (1978), *aff'd* 79-1 USTC ¶9220 (2nd Cir. 1979); *Tallon v. Comm.*, TC Memo 1979-423; *Johnson v. Comm.*, 74 TC 1057 (1980).
6. IRC Sec. 4973(a).
7. See Let. Rul. 7851087.
8. IRC Secs. 4973(b)(1)(A), 4973(f)(1)(A).
9. *Martin v. Comm.*, TC Memo 1993-399; *Michel v. Comm.*, TC Memo 1989-670.
10. SCA 200148051.

The IRS has ruled that earnings credited to an IRA that are attributable to a non-IRA companion account maintained at the same financial institution (a "super IRA") are treated as contributions to the IRA; when coupled with a cash contribution, these amounts may be an excess contribution subject to the penalty tax.[1] An interest bonus credited to an individual retirement account, however, is not included in the calculation of an excess contribution.[2]

3624. When can IRA contributions be withdrawn or reduced?

Any IRA contribution (excess or otherwise) may be withdrawn, together with the net income attributable to such contribution, on or before the due date (including extensions of time) for filing the federal income tax return of the contributing individual and the amount will be treated as if never contributed, regardless of the size of the contribution.[3] Thus, such a distribution is not included in gross income and is not subject to the 10 percent early distribution excise tax. Such a distribution of an excess contribution also is not subject to the 6 percent excess contribution excise tax. The accompanying distribution of the net income is includable in income and is subject to penalty as an early distribution (Q 3625, Q 3629).[4] Net income attributable to a contribution is determined by allocating to the contribution a pro-rata portion of the earnings or losses accrued by the IRA during the period the IRA held the contribution. Net income may be a negative amount.[5]

Relief may be granted for failure to meet the above deadline if the taxpayer has taken all necessary and reasonable steps, such as properly notifying the financial institution, to comply with the law.[6] Excess amounts that are not withdrawn by this method are subject to the 6 percent excise tax in the year of contribution and are carried over and taxed each year until the year the excess is eliminated.

By contributing less than the maximum limit in a year, an excess contribution in a previous year may be absorbed up to the unused maximum limit for the year.[7] With respect to traditional IRAs, both the amount contributed and the amount of excess absorbed may be deductible subject to the active participant rules (Q 3614) and no taxable income or early distribution tax is involved. The deduction must be reduced if the excess was improperly deducted in a year closed to IRS challenge.[8]

Where all or a portion of the excess is attributable to an excess "rollover" contribution that resulted from the individual's reliance on erroneous information supplied by the plan, trust, or institution making the distribution, distribution of the portion of the excess attributable to the erroneous information is not included in income and is not subject to the 10 percent early distribution tax.[9] It is not necessary to withdraw earnings on the excess, but any earnings withdrawn would be taxable income and subject to the 10 percent tax if early.

The excess also may be reduced by a distribution includable in income. Such a distribution is subject to the 10 percent excise tax if it is an early distribution, as well as income tax.

1. Rev. Rul. 85-62, 1985-1 CB 153.
2. Let. Rul. 8722068.
3. IRC Secs. 4973(b), 408(d)(4).
4. IRC Sec. 408(d)(4), flush language.
5. Treas. Reg. §1.408-11; Notice 2000-39, 2000-2 CB 132.
6. *Childs v. Comm.*, TC Memo 1996-267; *Thompson v. Comm.*, TC Memo 1996-266.
7. IRC Secs. 4973(b)(2), 4973(f)(2).
8. IRC Sec. 219(f)(6); Prop. Treas. Reg. §1.219-1(e).
9. IRC Sec. 408(d)(5)(B).

Where a taxpayer amended his tax return to include an excess contribution in income in the year contributed, the Tax Court ruled that the distribution of the excess in a later year was not includable under the rules of IRC Section 72, that the excess contribution included in income in the prior year constituted an "investment in the contract," and that as a result it was not taxable a second time on the actual distribution of such excess.[1] The phrase "aggregate amount of * * * consideration paid for the contract" found in IRC section 72(e)(6) encompassed the excess contribution made by the taxpayer. The contribution was therefore considered to be an amount paid in consideration for an IRA and, thus, an "investment in the contract." As a consequence, section 72 would provide a basis for the excess contribution and, upon distribution, such amount would be distributed tax-free.[2]

There is no 6 percent excess contributions excise tax on the amount of the reduction in the year of withdrawal.

For purposes of the excess contribution rules, if an excess contribution is invested in a time deposit (such as a CD) that is subject to an early withdrawal penalty of the trustee, the amount reportable as an excess contribution on distribution of the excess is the total amount actually distributed from the plan after the imposition of the early withdrawal penalty.[3]

A decline in asset value does not remove an excess contribution.[4]

3625. How are amounts distributed from a traditional IRA taxed?

Distributions from a traditional IRA generally are taxed under IRC Section 72 (relating to the taxation of annuities).[5] Under these rules, a portion of the distribution may be excludable from income. The amount excludable from the taxpayer's income for a year is that portion of the distribution that bears the same ratio to the amount received as the taxpayer's investment in the contract (i.e., nondeductible contributions) bears to the expected return under the contract. In no case will the total amount excluded exceed the unrecovered investment in the contract.[6]

All traditional IRAs are treated as one contract, all distributions during the year are treated as one distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year with or within which the taxable year begins.[7] Thus, the nontaxable portion of a distribution (whether from a traditional individual retirement annuity or account) is equal to the following:

$$\frac{\text{Unrecovered Nondeductible Contributions}}{\text{Total IRA Account Balance} + \text{Distribution amount} + \text{Outstanding Rollovers}} \times \text{Distribution Amount}$$

1. *Campbell v. Comm.*, 108 TC 54 (1997).
2. Id.
3. Let. Ruls. 8643070, 8642061.
4. H. R. Conf. Rep. 93-1280 (ERISA '74) *reprinted in* 1974-3 CB 501-502.
5. IRC Sec. 408(d)(1).
6. IRC Sec. 72(b).
7. IRC Sec. 408(d)(2).

The total IRA account balance is the balance in all traditional IRAs owned by the taxpayer, as of December 31 of the year of the distribution. To this amount is added the amount of any distributions made (i.e., the amounts for which the nontaxable portion is being computed) and any outstanding rollover amounts (i.e., any amount distributed by a traditional IRA within sixty days of the end of the year, which has not yet been rolled over into another plan, but which is rolled over in the following year). If it is not rolled over, the amount is not treated as an outstanding rollover.[1]

> *Example*: Bill King has made nondeductible contributions to a traditional IRA totaling \$2,000, giving him a basis at the end of 2013 of \$2,000. By the end of 2014, his IRA earns \$400 in interest income. In that year, Bill receives a distribution of \$600. Of the \$600 received by Bill, the nontaxable portion of the distribution is equal to \$500, calculated as follows:
>
> $$\frac{\$2{,}000 \text{ [total unrecovered nondeductible contributions]}}{\$2{,}400 \text{ [total IRA account balance + distribution]}} \times \$600 \text{ [distribution amount]}$$
>
> Thus, Bill will be taxed on only \$100 of the \$600 distribution and remaining IRA account balance will be \$1,800 (\$2,000+\$400 - \$600).

Nondeductible contributions will not be excluded from gross income as investment in the contract where the taxpayer is unable to document the nontaxable basis through the filing of Form 8606, Nondeductible IRAs (Contributions, Distributions and Basis) for the year in which such nondeductible contributions were made and the year in which they were distributed (Q 3648).[2]

An individual may recognize a loss on a traditional IRA, but only when all amounts have been distributed from all traditional IRAs and the total distributed is less than the individual's unrecovered basis.[3] The deduction for the loss is a miscellaneous itemized deduction.[4]

Despite the pro-rata rule applicable generally to distributions from a traditional IRA, distributions after 2001 that are rolled over to a qualified plan, an IRC Section 403(b) tax sheltered annuity, or an eligible IRC Section 457 governmental plan are treated as coming first from all non-after-tax contributions and earnings in all of the IRAs of the owner.[5] Because after-tax contributions cannot be rolled over to eligible retirement plans other than another IRA (Q 3883, Q 3891), this ordering rule effectively allows the owner to rollover the maximum amount permitted. Appropriate adjustments must be made in applying IRC Section 72 to other IRA distributions in the same taxable year and subsequent years.[6]

The fact that IRA funds were distributed by the financial institution's receiver following insolvency proceedings did not change the nature of the distribution. The taxpayers were taxed on the distribution since a timely rollover was not made.[7]

1. Notice 87-16, 1987-1 CB 446.
2. *Alpern v. Comm.*, TC Memo 2000-246.
3. Notice 87-16, 1987-1 CB 446.
4. See IRS Pub 590 (2013), p. 48.
5. IRC Sec. 408(d)(3)(H).
6. IRC Sec. 408(d)(3)(H)(ii)(III).
7. *Aronson v. Comm.*, 98 TC 283 (1992).

Likewise, the transfer of IRA funds by a financial institution into a "trust account" was a taxable distribution to the taxpayer even though the taxpayer had intended to transfer the IRA funds to another IRA and had named the account a "trust IRA" because the money was transferred into the trust account.[1]

In addition, a failed Roth IRA conversion that is not recharacterized is treated as a distribution from a traditional IRA and taxed accordingly.[2]

Taxpayers who were defrauded of their account balances by their investment advisor, who convinced them to make IRA rollover investments that the advisor subsequently embezzled, were liable for taxes on the amount of assets stolen because the account holders failed to take the necessary steps required to properly set up IRA rollover accounts.[3]

Unless a taxpayer elects otherwise, any amount of a qualified hurricane distribution required to be included in gross income shall be so included ratably over the three year taxable period beginning with such year.[4]

If a qualified hurricane distribution is an eligible rollover distribution (Q 3891), it may be recontributed to an eligible rollover plan no later than three years from the day after such distribution was received (Q 3895).[5]

Certain early distributions are subject to additional tax (Q 3629). As to what constitutes a "deemed distribution" from a traditional IRA, see Q 3608. For the estate tax marital deduction implications of distributions from a traditional IRA, see Q 3660.

3626. How are amounts distributed from a Roth IRA taxed?

Where a Roth IRA contains both contributions and conversion amounts, there are ordering rules that apply in determining which amounts are withdrawn. In applying the ordering rules, traditional IRAs are not aggregated with Roth IRAs. All Roth IRAs are aggregated with each other. Regular Roth IRA contributions are deemed to be withdrawn first, then converted amounts second (in order if there has been more than one conversion). Withdrawals of converted amounts are treated first as coming from converted amounts that were includable in income. The ordering rules continue to treat earnings as being withdrawn after contributions.[6]

"Qualified distributions" from a Roth IRA are not includable in gross income. Thus, earnings are tax-free, not tax deferred as with traditional IRAs. A "qualified distribution" is any distribution made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA (or such individual's spouse made a contribution to a Roth IRA) established for such individual and such distribution meets one of the following requirements.

1. Let. Rul. 199901029.
2. SCA 200148051.
3. FSA 199933038.
4. IRC Sec. 1400Q; Notice 2005-92, 2005-2 CB 1165.
5. IRC Sec. 1400Q; Notice 2005-92, 2005-2 CB 1165.
6. IRC Sec. 408A(d)(4); Treas. Reg. §1.408A-6, A-8.

(1) It is made on or after the date on which the individual attains age 59½

(2) It is made to a beneficiary (or to the estate of the individual) on or after the death of the individual

(3) It is attributable to the individual's being disabled (within the meaning of IRC Section 72(m)(7)).

(4) It is a "qualified first-time homebuyer distribution" (see below).[1]

A "qualified first-time homebuyer distribution" is any payment or distribution that is used within 120 days after the day it was received by the individual to pay the qualified acquisition costs of a principal residence of a first-time homebuyer.[2] The aggregate amount of payments or distributions received by an individual from all Roth and traditional IRAs that may be treated as qualified first-time homebuyer distributions is limited to a lifetime maximum of $10,000.[3] The first-time homebuyer may be the individual, his or her spouse, any child, grandchild, or ancestor of the individual or his or her spouse. A first-time homebuyer is further defined as an individual (and, if married, such individual's spouse) who has had no present ownership interest in a principal residence during the two year period ending on the date of acquisition of the residence for which the distribution is being made.[4] The date of acquisition is the date on which a binding contract to acquire the residence is entered into or the date construction or reconstruction of the residence begins.[5] Qualified acquisition costs are defined as the costs of acquiring, constructing, or reconstructing a residence, including reasonable settlement, financing, or other closing costs.[6]

In calculating the five-taxable-year period, it is important to remember that contributions to Roth IRAs, as with traditional IRAs, may be made as late as the due date for filing the individual's tax return for the year (without extensions) (Q 3613). Thus, if a contribution is made to a Roth IRA between January 1, 2014 and April 15, 2014 for the 2013 taxable year, the five-taxable-year holding period begins to run in 2013.

For purposes of determining whether a distribution from a Roth IRA that is allocable to a "qualified rollover contribution" (Q 3617) from a traditional IRA is a "qualified distribution," the five-taxable-year period begins with the taxable year for which the conversion applies. A subsequent conversion will not start the running of a new five-taxable-year period.[7]

The five-taxable-year period for determining a "qualified distribution" is not recalculated on the death of the Roth IRA owner; the five-taxable-year period of the beneficiary includes the period the Roth IRA was held by the decedent.[8]

1. IRC Secs. 408A(d).
2. IRC Sec. 72(t)(8)(A).
3. IRC Sec. 72(t)(8)(B).
4. IRC Sec. 72(t)(8)(D)(i).
5. IRC Sec. 72(t)(8)(d)(iii).
6. IRC Sec. 72(t)(8)(C).
7. IRC Sec. 408A(d)(2)(B).
8. Treas. Reg. §1.408A-6, A-7.

Any nonqualified distribution will be includable in income, but only to the extent that the distribution, along with all previous distributions from the Roth IRA, exceeds the aggregate amount of contributions to the Roth IRA. For this purpose, all Roth IRAs are aggregated. To the extent such distributions are taxable, the 10 percent early distribution penalty may apply (Q 3629). Distributions allocable to "qualified rollover contributions" (Q 3617) will be subject to the early distribution penalty regardless of whether the distribution is taxable if the distribution is made within the five-year period beginning with the tax year in which the contribution was made.[1] Distributions of excess contributions and earnings on these contributions are not qualified distributions.[2]

An individual may recognize a loss on a Roth IRA, but only when all amounts have been distributed from all Roth IRAs and the total distributed is less than the individual's unrecovered Roth IRA contributions.[3] The deduction for the loss is a miscellaneous itemized deduction.[4]

A transfer of a Roth IRA by gift would constitute an assignment of the Roth IRA, with the effect that the assets of the Roth IRA would be deemed to be distributed to the Roth IRA owner and, accordingly, treated as no longer held in a Roth IRA.[5]

Unless a taxpayer elects otherwise, any amount of a qualified hurricane distribution required to be included in gross income shall be so included ratably over the three year taxable period beginning with the year of distribution.[6]

If a qualified hurricane distribution is an eligible rollover distribution (Q 3891), it may be recontributed to an eligible rollover plan no later than three years from the day after such distribution was received (Q 3895).[7]

For the estate tax marital deduction implications of distributions from a Roth IRA, see Q 3660.

3627. Are the death proceeds of an individual retirement endowment contract taxable?

An endowment contract is a policy under which a person is paid a specified amount of money on a certain date unless he or she dies before that date, in which case, the money is paid to a designated beneficiary. Endowment proceeds paid in a lump sum at maturity are taxable only if the proceeds are more than the cost of the policy. To determine the cost, subtract any amount previously received under the contract, and exclude from income the total premiums (or other consideration) paid for the contract. Include the part of the lump sum payment that is more than the cost in income.[8]

1. Treas. Reg. §1.408A-6, A-5.
2. See IRC Sec. 408A(d).
3. Notice 87-16, 1987-1 CB 446.
4. See IRS Pub 590 (2013), p. 48.
5. Treas. Reg. §1.408A-6, A-19.
6. IRC Sec. 1400Q; Notice 2005-92, 2005-2 CB 1165.
7. IRC Sec. 1400Q; Notice 2005-92, 2005-2 CB 1165.
8. IRS Pub. 17 (2011).

If no nondeductible contributions (Q 3614) have been made by the taxpayer to any traditional individual retirement plan, the portion of the death benefit of an endowment contract equal to the cash value immediately before death is included in gross income as a federal income taxable distribution. The balance is federal income tax-free as proceeds of life insurance under IRC Section 101(a). If the death benefit is paid in installments, the amount representing life insurance proceeds is prorated and recovered tax-free under IRC Section 101(d).[1]

If nondeductible contributions to any such individual retirement plan have been made, it would seem that a portion of the cash value of the contract should be treated as a recovery of basis and, as such, nontaxable (Q 3625).

3628. Are amounts received from IRAs subject to withholding?

Yes.

Taxable distributions from traditional IRAs are subject to income tax withholding. If the distribution is in the form of an annuity or similar payments, amounts are withheld as though each distribution were a payment of wages pursuant to the recipient's Form W-4. In the case of any other kind of distribution, a flat 10 percent is withheld.[2] Even though distributions from a traditional IRA may be partly nontaxable because of nondeductible contributions, the payor must report all withdrawn amounts to the IRS.[3] A recipient generally can elect not to have the tax withheld; this election will continue until the recipient revokes the election.[4]

Planning Point: A recipient of a taxable IRA distribution should project his or her income tax liability for the year and pay in an appropriate amount of estimated tax payments to avoid penalties for under-withholding. Withholding of 10 percent or even 20 percent may be insufficient to cover federal income tax liability. Taxpayers should project their state and local tax liabilities as well. *Martin Silfen, J.D., Brown Brothers, Harriman Trust Co., LLC*.

Distributions from Roth IRAs are subject to income tax withholding, but only to the extent that it is reasonable to believe the amount withdrawn would be includable in income.[5]

3629. What penalties apply to early distributions from an IRA?

Except as noted below, amounts distributed from a traditional IRA or a Roth IRA to the individual for whom the plan is maintained before such individual reaches age 59½ are early (premature) distributions. To the extent such distributions are taxable, they are subject to an additional tax equal to 10 percent of the amount of the distribution that is includable in gross income in the tax year.[6] The tax is increased to 25 percent in the case of distributions from SIMPLE IRAs (Q 3654) during the first two years of participation.[7]

The 10 percent penalty tax does not apply to the following.

1. Treas. Reg. §1.408-3(e)(2).
2. IRC Sec. 3405(e)(1)(A); Treas. Reg. §35.3405-1.
3. IRC Sec. 3405(e)(1)(B).
4. IRC Secs. 3405(a)(2), 3405(b)(2).
5. IRC Sec. 3405(e)(1)(B).
6. IRC Sec. 72(t).
7. IRC Sec. 72(t)(6).

(1) Distributions made to a beneficiary or the individual's estate on or after the death of the individual.[1]

Planning Point: If a surviving spouse is under age 59½ and elects to be treated as the owner of a decedent spouse's IRA (generally, for required minimum distribution purposes), distributions may be subject to the early distribution penalty unless an exception applies. The early distribution penalty would not apply to distributions after the death of the original owner in the absence of the spouse making the election to be treated as owner.

(2) Distributions attributable to the individual's disability.[2]

(3) Distributions made for medical care, but only to the extent allowable as a medical expense deduction for amounts paid during the taxable year for medical care (determined without regard to whether the individual itemizes).[3] Thus, only amounts in excess of 10 percent of the individual's adjusted gross income ("AGI") escape the 10 percent penalty. (The threshold amount was 7.5 percent for tax years prior to 2013).

(4) Distributions made to unemployed individuals for the payment of health insurance premiums. The AGI floor, described above, does not have to be met if the individual has received unemployment compensation for at least twelve weeks and the withdrawal is made in either the year such unemployment compensation was received or the year immediately following the year in which the unemployment compensation was received. This exception also applies to self-employed individuals whose sole reason for not receiving unemployment compensation is that they were self-employed. The exception ceases to apply once the individual has been reemployed for a period of sixty days.[4]

Planning Point: If an IRA owner pays health insurance premiums in a year of unemployment, and the owner expects to need an IRA distribution within the next few years at a time when the owner does not anticipate that any other exception will apply, the owner should consider taking an IRA distribution in the year of unemployment to avoid a future penalty tax on that amount. *Martin Silfen, J.D., Brown Brothers, Harriman Trust Co., LLC.*

(5) Distributions made to pay "qualified higher education expenses" during the taxable year for the taxpayer, the taxpayer's spouse, or the child or grandchild of the taxpayer or the taxpayer's spouse.[5] "Qualified higher education expenses" means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the student at any "eligible educational institution." For tax years beginning after 2001, this includes expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Room and board (up to a certain amount) also is included if the student is enrolled at least half-time.[6] "Qualified higher education expenses"

1. IRC Sec. 72(t)(2)(A)(ii).
2. IRC Sec. 72(t)(2)(A)(iii).
3. IRC Secs. 72(t)(2)(B)
4. IRC Sec. 72(t)(2)(D).
5. IRC Sec. 72(t)(2)(E).
6. IRC Secs. 72(t)(7), 529(e)(3).

must be incurred for the taxable year of the distribution.[1] These expenses must be reduced by any scholarships received by the individual, any educational assistance provided to the individual, or any payment for such expenses (other than a gift, devise, bequest, or inheritance) that is excludable from gross income.[2] An "eligible educational institution" is any college, university, vocational school, or other post-secondary educational institution described in Section 481 of the Higher Education Act of 1965.[3] Thus, virtually all accredited public, nonprofit, and proprietary postsecondary institutions are considered eligible educational institutions.[4] This exception to the 10 percent penalty is not available if the withdrawal qualifies for one of the other exceptions provided under IRC Section 72(t)(2) (other than the following exception for "qualified first-time homebuyers").[5]

Planning Point: If an IRA owner has higher education expenses in a year and he or she expects to need an IRA distribution within the next few years at a time when he or she does not anticipate that any other exception will apply, the IRA owner should consider taking an IRA distribution in the year of the higher education expenses to avoid a future penalty tax on that amount. *Martin Silfen, J.D., Brown Brothers, Harriman Trust Co., LLC.*

(6) Distributions that are "qualified first-time homebuyer distributions" (Q 3626). This exception to the 10 percent penalty is not available if the withdrawal qualifies for one of the other exceptions provided under IRC Section 72(t)(2).[6]

(7) Distributions that are part of a series of substantially equal periodic payments made (at least annually) for the life or life expectancy of the individual or the joint lives or joint life expectancy of the individual and his or her designated beneficiary (Q 3631).[7]

(8) Distributions that are "qualified hurricane distributions" which distributions may not exceed $100,000.[8]

(9) Distributions that are "qualified reservist distributions." Qualified reservist distributions are those made to reserve members of the U.S. military called to active duty for 180 days or more at any time after September 11, 2001. Reservists have the right to return the amount of any distributions to the retirement plan for two years following the end of active duty.[9]

The penalty tax has been held not to apply to compulsory distributions where the IRS levied on a taxpayer's IRA and where the federal government seized a taxpayer's IRA as part of a plea agreement.[10]

1. *Lodder-Beckert v. Comm.*, T.C. Memo 2005-162 (2005).
2. IRC Sec. 72(t)(7)(B).
3. See IRC Sec. 529(e)(5).
4. Notice 97-60, 1997-2 CB 310, at 14 (Sec. 3, A16).
5. IRC Sec. 72(t)(2)(E).
6. IRC Sec. 72(t)(2)(F).
7. IRC §72(t)(2)(A)(iv).
8. IRC Sec. 1400Q; Notice 2005-92, 2005-2 CB 1165.
9. IRC Sec. 72(t)(2)(G).
10. *Larotonda v. Comm.*, 89 TC 287 (1987), nonacq.; *Murillo v. Comm.*, TC Memo 1998-13, affd. 166 F.3d 1201 (2nd Cir. 1998).

Where a taxpayer withdrew from his IRA to satisfy a court order to pay alimony and child support, the penalty tax did apply.[1]

No early distribution occurs where accumulation units in an individual retirement annuity are surrendered to purchase a disability waiver of premium feature.[2] Ineligibility to set up an individual retirement plan does not prevent imposition of this penalty.[3] The fact that an IRA distribution was mandated by the insolvency of the financial institution issuing the IRA did not prevent the application of the 10 percent penalty tax when the funds were received and not rolled over.[4]

The amount reportable as an early distribution from a time deposit (such as a certificate of deposit) that is subject to an early withdrawal penalty of the trustee is the net amount of the distribution after deduction of any early withdrawal penalty imposed by the trustee.[5]

It appears that amounts includable in income as a result of a prohibited transaction, borrowing on an annuity contract, or using an account as security for a loan would be subject to the 10 percent penalty.

3630. What strategies should a taxpayer consider when determining the level of distributions from retirement accounts during retirement?

One traditional method for determining the level of distributions that a taxpayer should take from retirement accounts during retirement is the 4 percent rule. An alternative, however, can be to use the IRS' required minimum distribution (RMD) rules to make the determination.

The RMD rules essentially require that your clients begin withdrawing funds from tax-deferred retirement accounts, such as IRAs and 401(k)s, when they reach age 70½. The minimum amounts that must be withdrawn are calculated based on the taxpayer's life expectancy, determined using IRS actuarial data.[6]

The IRS provides tables specifying the percentage of current account assets that must be withdrawn each year based on the life expectancy of the taxpayer in any given year after reaching age 70½ (tables are also available for taxpayers beginning withdrawals at younger ages). In the case of a married couple where one spouse is more than ten years younger than the other, the joint life expectancy of the couple is used in the calculation to provide a more realistic estimate of the life expectancy.[7]

The RMD requirements are generally not meant to provide retirees with guidance on the optimal withdrawal rate, but are meant to ensure that the funds in these tax-deferred accounts are used for retirement income, rather than as estate planning vehicles. Because the requirements seek to ensure that the assets are spent during life, they are a viable alternative to the so-called "4 percent rule," even though this was not the original IRS intent in formulating the rules.

1. *Baas v. Comm.*, TC Memo 2002-130. See also *Czepiel v. Comm.*, TC Memo 1999-289, affd. by order (1st Cir. 2000).
2. See Let. Rul. 7851087.
3. *Orzechowski v. Comm.*, 69 TC 750 (1978), *aff'd* 79-1 USTC ¶7220 (2nd Cir. 1979).
4. *Aronson v. Comm.*, 98 TC 283 (1992).
5. Let. Ruls. 8643070 and 8642061.
6. IRC Secs. 408(a)(6), 408(b)(3), 401(a)(9).
7. Treas. Reg. §1.401(a)(9)-9.

As the name suggests, under the 4 percent rule, the taxpayer withdraws 4 percent of the beginning balance of retirement savings each year during retirement. While the rule is very simple, it can have unintended consequences. For example, the rigid 4 percent-per-year requirement tends to encourage taxpayers to seek out dividend-heavy investments to supplement their otherwise fixed income, regardless of whether those investments are otherwise appropriate.

Further, the 4 percent rule has taxpayers withdraw 4 percent even in years when their assets may have severely underperformed. The converse is also true, as the rule limits taxpayers to 4 percent withdrawals even if they could afford much more.

Some advisors find that the RMD method should be considered as a potential alternative for determining retirement account withdrawal rates to the traditional 4 percent rule. Not only is the RMD approach almost as simple as the 4 percent rule—rather than withdrawing 4 percent each year, the taxpayer would consult the IRS tables to determine the applicable percentage—but it offers much more flexibility.

The RMD rule may be, in many ways, much more realistic than the 4 percent rule because it bases withdrawals on the current value of the taxpayer's retirement assets. While this requires determining the account values each year, it also allows taxpayers to modify their consumption levels based on actual account performance. Because the percentages are based on life expectancy and vary with age, it is still unlikely that the taxpayer will outlive his assets.

3631. How are substantially equal periodic payments from an IRA calculated for purposes of IRC Section 72(t)?

The 10 percent early (premature) distribution tax (Q 3629) does not apply to distributions that are part of a series of substantially equal periodic payments made at least annually for the life or life expectancy of the individual or the joint lives or joint life expectancy of the individual and his or her designated beneficiary.[1]

The IRS has approved three methods, explained below, under which payments will be considered to be "substantially equal periodic payments."[2] Regardless of which method is used, the series of payments must continue for the longer of five years or until the individual reaches age 59½. Ordinarily, a "modification" (see below) that occurs before this duration requirement is met will result in the penalty and interest being imposed on the entire series of payments, in the year the modification occurs.[3] A "one time election" (see below) to change methods is permitted if certain requirements are met.[4] A change in the payment series as a result of disability or death also does not trigger the penalty.[5]

The three approved methods are as follows:

The required minimum distribution ("RMD") method requires use of a calculation that would be acceptable for purposes of calculating the required minimum distributions under IRC

1. IRC Sec. 72(t)(2)(A)(iv).
2. Rev. Rul. 2002-62, 2002-2 CB 710, modifying Notice 89-25, 1989-1 CB 662, A-12.
3. IRC Sec. 72(t)(4)
4. Rev. Rul. 2002-62, 2002-2 CB 710.
5. IRC Sec. 72(t)(4).

Section 401(a)(9). Consequently, the account balance, the life expectancy, and the resulting annual payments are redetermined each year. Such annual fluctuations will not be considered modifications.[1] Under this method, the same life expectancy table used for the first distribution year must be used for each following year.[2] Although the Worker, Retiree and Employer Recovery Act of 2008 ("WRERA 2008") waived RMDs for 2009, this does not apply for purposes of the substantially equal periodic payment exception to the early distribution penalty.[3]

The fixed amortization method, under which the annual payment is determined by amortizing the individual's account balance in level amounts over a specified number of years determined using the chosen life expectancy and interest rate as explained below.[4] The account balance, life expectancy, and resulting annual payment are determined once for the first distribution year, and the annual payment is the same amount in each year thereafter.[5] The ability to recalculate the amount of the payment each year by using the taxpayer's life expectancy with the amortization method was approved in a letter ruling.[6]

The fixed annuitization method, under which the annual payment is determined by dividing the individual's account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the individual's age attained in the first distribution year and continuing for the life of the individual (or the joint lives of the individual and a beneficiary). The annuity factor is derived using the mortality table provided in a 2002 IRS guidance and an interest rate chosen as explained below. The account balance, annuity factor, interest rate, and resulting annual payment all are determined once for the first distribution year and the annual payment is the same amount each year thereafter.[7] The ability to recalculate the amount of the payment each year by using the taxpayer's life expectancy with the annuitization method was approved in a letter ruling.[8]

There are three life expectancy table options in the 2002 guidance, all taken from the 2002 RMD regulations:[9] the single life expectancy table, the joint and last survivor life expectancy table, and the uniform lifetime table. (Because the uniform lifetime table in the RMD regulations begins at age 70, the IRS included an expanded version covering a broader range of ages).[10] All three tables are reproduced in Appendix F.

An interest rate must be used that does not exceed 120 percent of the federal mid-term rate (determined in accordance with IRC Section 1274(d)) for either of the two months immediately preceding the month in which the distribution begins.[11]

1. Rev. Rul. 2002-62, 2002-2 CB 710, Sec. 2.01(a).
2. Rev. Rul. 2002-62, 2002-4 CB 710, Sec. 2.02(a).
3. Notice 2009-82, 2009-2 CB 491.
4. Rev. Rul. 2002-62, 2002-2 CB 710, Sec. 2.01(b).
5. Rev. Rul. 2002-62, 2002-2 CB 710, Sec. 2.01(b).
6. Let. Rul. 200432021.
7. Rev. Rul. 2002-62, 2002-2 CB 710, Sec. 2.01(c).
8. Let. Rul. 200432023.
9. See Treas. Reg. §1.401(a)(9)-9.
10. Rev. Rul. 2002-62, 2002-2 CB 710, Sec. 2.02(a).
11. Rev. Rul. 2002-62, 2002-2 CB 710, Sec. 2.02(c).

The IRS has stated that individual retirement plans did not have to be aggregated for purposes of calculating a series of substantially equal periodic payments.[1] If a taxpayer owns more than one IRA, any combination of the IRAs may be taken into account in determining the distributions by aggregating the account balances of those IRAs. But a portion of one or more of the IRAs may not be excluded to limit the periodic payment to a predetermined amount.[2]

Planning Point: The ability to split up or aggregate IRAs in advance of a payout makes the calculation extremely flexible. Furthermore, creating separate accounts is a good way to avoid tying up any more IRA funds than is absolutely necessary to support the needed payout.

If an individual with more than one IRA chooses to base a series of substantially equal periodic payments on the total of all of his or her IRAs, the annual distribution may be received from any or all of the accounts.[3]

Planning Point: It generally is useful to select the substantially equal periodic payment method that comes closest to withdrawing the amount that is desired. Under the amortization or annuitization methods, higher interest rates result in higher payments; lower interest rates result in lower payments. In general, having a designated beneficiary can reduce the amount of the payments (calculations can be based on two lives rather than one); a younger beneficiary results in lower payments, an older beneficiary results in higher payments. Selecting IRA accounts with a lower aggregate account balance results in lower payments; selecting IRA accounts with a higher aggregate account balance results in higher payments.

3632. When is a series of substantially equal periodic payments from an IRA "modified" and what are the results?

Except in the event of death or disability, a change in payouts after the series has begun generally will constitute a "modification" and, thus, will trigger the penalty.[4] The IRS has determined that a change that does not alter the annual payout (such as a change from quarterly to monthly payments) is not a modification for this purpose.[5] The receipt of a qualified hurricane distribution (Q 3625) will not be treated as a change in a series of substantially equal periodic payments.[6]

The IRS has stated that an individual who begins distributions using either the amortization method or the annuitization method may, in any subsequent year, switch to the RMD method to determine the payment for the year of the switch and all subsequent years. Regardless of when the payments began, a taxpayer making such a change will not be treated as having made a "modification."[7]

Planning Point: The ability to switch to the RMD method makes the amortization and annuity methods more attractive, particularly for a participant who has a short term need for larger distributions which he or she expects will diminish in a few years. *Martin Silfen, J.D., Brown Brothers, Harriman Trust Co., LLC., New York, New York*.

1. See Let. Ruls. 200309028, 9050030.
2. Let. Rul. 9705033.
3. See Let. Rul. 9705033.
4. IRC Sec. 72(t)(4).
5. See Let. Rul. 8919052.
6. Notice 2005-92, 2005-2 CB 1165, Sec. 4H.
7. Rev. Rul. 2002-62, 2002-2 CB 710, Sec. 2.03(b).

A modification to the series of payments generally will occur if the taxpayer makes any of the following: (1) any addition to the account balance (other than gains or losses); (2) any non-taxable transfer of a portion of the account balance to another retirement plan; or (3) a rollover of the amount received, resulting in such amount not being taxable.[1]

A taxpayer who made the one-time RMD method change late in 2002 was permitted to roll over amounts in excess of the RMD amount back to the IRA in early 2003 even though the sixty day limit (Q 3895) had elapsed.[2] The IRS determined that an inadvertent rollover of a small IRA balance into a large IRA from which a series of substantially equal periodic payments was in progress was not a modification.[3]

Planning Point: Qualified plans often make a trailing distribution subsequent to making a lump sum distribution to a former employee's IRA. The IRS currently holds the position that if the participant has started a 72(t) payout from the receiving IRA, the trailing distribution will trigger a modification. Participants starting a 72(t) payout following a lump sum distribution should consider moving the funds to a different IRA prior to beginning the payout. *Robert S. Keebler, CPA, MST, Virchow, Krause & Company, LLP, Green Bay, Wisconsin*.

The commencement of another series of substantially equal periodic payments (i.e., from a different IRA) does not constitute a modification of an existing payout, and the IRS has stated privately that nothing in the IRC or regulations prevents a subsequent payout series.[4] One case determined that a distribution from an IRA that satisfied the early distribution penalty exception for qualified higher education expenses was not a modification of a series of substantially equal periodic payments from the same IRA.[5]

3633. What are the results if an IRA account owner depletes the IRA account through properly determining substantially equal periodic payments?

The penalty under IRC Section 72(t) will not be applied if, as a result of applying an acceptable method of determining substantially equal periodic payments, an individual depletes his or her account and is unable to complete the payouts for the required duration period under IRC Section 72(t)(4).[6]

3634. What are the minimum distribution requirements for individual retirement plans?

Amounts accumulated in an individual retirement account or annuity ("IRA") must be distributed in compliance with the minimum distribution requirements.[7] The amount that must be distributed each year according to these rules is commonly referred to as the "required minimum distribution" (or RMD). For the calculation of lifetime distributions, see Q 3637;

1. Rev. Rul. 2002-62, 2002-2 CB 710, Sec. 2.02(e).
2. Let. Rul. 200419031.
3. See Let. Rul. 200616046.
4. See Let. Rul. 200033048.
5. *Benz v. Comm.*, 132 TC 330 (2009).
6. Rev. Rul. 2002-62, 2002-2 CB 710, Secs. 2.03(a) and 3.
7. IRC Secs. 408(a)(6), 408(b)(3), 401(a)(9).

for after-death distributions, see Q 3638. Reporting requirements pertaining to IRA required minimum distributions are explained in Q 3589.

Roth IRAs are not subject to the lifetime minimum distribution requirements, but are subject to the after-death distribution requirements explained in Q 3638.

Traditional IRAs, SEP IRAs, and SIMPLE IRAs (non-Roth IRAs) generally are subject to the same minimum distribution requirements that apply to qualified plans, with some variations (Q 3802 to Q 3814).[1] The required beginning date for lifetime distributions from non-Roth IRAs is April 1 of the calendar year following the calendar year in which the individual attains age 70½ (Q 3637).[2] An individual reaches age 70½ on the date that is six calendar months after his or her 70th birthday.[3]

Planning Point: WRERA 2008 provided that RMDs from IRAs for calendar year 2009 were waived. Also, the five year rule was determined without regard to 2009. A person who received an RMD for 2009 (including a distribution for 2009 made as late as April 1, 2010) had until the later of sixty days after receiving the RMD or November 30, 2009, to roll over the RMD to an IRA or other retirement plan (assuming the rollover would otherwise qualify).[4]

3635. How are minimum distribution requirements calculated if an individual owns more than one IRA?

If an individual owns more than one IRA, the required minimum distribution (RMD) must be calculated separately for each IRA, but the total for a category (Roth or non-Roth) may be taken from any one or more of the IRAs within the same category. This rule requires aggregation of amounts that an individual is required to take as the IRA owner and a separate aggregation for amounts that an individual is required to take as the designated beneficiary of a decedent's IRA. Amounts taken as an IRA owner may not be aggregated with amounts taken as a beneficiary for purposes of meeting the minimum distribution requirements. Similarly, distributions from 403(b) contracts or annuities may not be aggregated with IRA distributions to meet the distribution requirements for either type of account.[5]

Example: Mark, who is 71 years old, has two IRA accounts that he contributed to during his working years and inherited an IRA from his deceased father. One of his IRA's has $50,000 (IRA 1) and the other has $75,000 (IRA 2); the inherited IRA has a balance of $25,000. Mark's required minimum distribution from these accounts is as follows:

IRA 1 = $1887 IRA 2 = $2830

Inherited IRA = $943.

Mark must take, in total, $4717 ($1887+ 2830) from his IRAs, but could take this amount from either IRA 1 or IRA 2 (or a combination of the two). The $943 required from the inherited IRA, however, must be taken only from that account.

1. Treas. Reg. §1.408-8, A-1, A-2.
2. Treas. Reg. §1.408-8, A-3.
3. Treas. Reg. §1.401(a)(9)-2, A-3.
4. Notice 2009-82, 2009-2 CB 491.
5. Treas. Reg. §1.408-8, A-9.

When an RMD is required during a calendar year, any amount distributed or withdrawn from the account will first be treated as the required distribution amount until the total required distribution has been satisfied. Consequently, such a distribution is not eligible for rollover.[1] However, the minimum distribution requirement may be satisfied by a distribution from another IRA owned by the same individual.[2]

In the event of a transfer from one IRA to another, the transferor IRA must distribute any amount required under these minimum distribution rules in the year of transfer--i.e. the transfer itself will not count as a distribution that satisfies these minimum distribution rules.[3]

3636. Is there a penalty imposed for failure to comply with IRA required minimum distribution requirements?

A penalty tax is imposed on the payee (IRA owner) if the amount distributed under an IRA for a calendar year is less than the required minimum distribution for the year. The penalty is equal to 50 percent of the amount by which the distribution made in the calendar year falls short of the required amount. The tax is imposed on the payee.[4] The penalty generally will be imposed in the calendar year in which the amount was required to be distributed. If the distribution was the first required distribution, and thus was due by April 1 following the calendar year in which the IRA owner reached 70 ½ years old (the required beginning date), the penalty will be imposed in the calendar year when distributions were to begin even though the required distribution was technically for the preceding year.[5]

> *Example*: Joan turned 70 ½ on October 26 of 2014. Her first required minimum distribution for 2014 was due by April 1, 2015. Joan did not receive such amount by the April 1 due date. Consequently, Joan will owe a penalty equal to 50 percent of the amount that should have been distributed, which will be imposed on her 2015 tax return.

The penalty tax may be waived if the payee establishes to the satisfaction of the IRS that the shortfall was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.[6]

The minimum distribution requirements will not be treated as violated, and, the 50 percent excise tax will not apply, where a shortfall occurs because assets are invested in a contract issued by an insurance company in state insurer delinquency proceedings.[7]

3637. How are the minimum distribution requirements met during an IRA owner's lifetime?

Distributions from a non-Roth individual retirement account ("IRA") or annuity must begin by April 1 of the year after the year in which the owner reaches age 70½, whether or

1. Treas. Reg. §1.408-8, A-4.
2. Treas. Reg. §1.408-8, A-9.
3. Treas. Reg. §1.408-8, A-8.
4. IRC Sec. 4974(a); Treas. Reg. §54.4974-1.
5. Treas. Regs. §§54.4974-2, A-1, 54.4974-2, A-6.
6. IRC Sec. 4974; Treas. Reg. §54.4974-2, A-7(a).
7. Treas. Reg. §1.401(a)(9)-8, A-8.

not the owner has retired.[1] Non-Roth IRA owners working beyond age 70½ are not permitted to delay distributions until after retirement, even under an employer-sponsored plan such as a SEP or SIMPLE IRA. Unless the owner's entire interest is distributed on or before the required beginning date, distributions of the balance must begin by that date and must, at a minimum, be distributed over the time period explained below.

No minimum distribution is required during life from a Roth IRA.

Planning Point: RMDs were waived for 2009. A distribution for 2009 that, under prior law, had to have been made by December 31, 2009 could be waived. A distribution for 2009 that must have been made by a beginning date of April 1, 2010 could also be waived. But a distribution for 2008 that was required to be made by a beginning date of April 1, 2009 could not be waived.

Uniform Lifetime Table

Required minimum distributions from a non-Roth individual retirement arrangement during the owner's lifetime are calculated by dividing the owner's account balance by the applicable distribution period determined from the RMD Uniform Lifetime Table found in Appendix F.[2] The amount of an individual's lifetime required distribution is calculated without regard to the beneficiary's age, except in the case of a spouse who is the sole beneficiary and who is more than ten years younger than the owner.[3]

The distribution required by April 1 is actually the distribution required for the year in which the owner attains age 70½. Distributions for each calendar year after the year the owner becomes age 70½ (including the year of the required beginning date) must be made by December 31 of that year.[4]

For purposes of calculating minimum distributions from an IRA for a calendar year, the account balance is determined as of December 31 of the immediately preceding calendar year (i.e., the valuation calendar year).[5]

> *Example*: Ms. Getman is an IRA owner born on July 1, 1941. She reached age seventy on July 1, 2012, and age 70½ on January 1, 2013 (i.e., six months after her birthday). Consequently, Ms. Getman's required beginning date is April 1, 2014. Assume that as of December 31, 2012, the value of Ms. Getman's IRA was $265,000. Because Ms. Getman's age in 2013 (the year for which her first distribution will be made) is seventy-one, the applicable distribution period from the Uniform Lifetime Table is 26.5 years. Thus, the required distribution for calendar year 2013 is $10,000 ($265,000 ÷ 26.5). Assume that Ms. Getman receives this amount shortly before her required beginning date of April 1, 2014.
>
> Assume that the value of Ms. Getman's account balance as of December 31, 2013 is $255,000. This account balance is not reduced by the distribution received in early 2014. As a result, Ms. Getman's required minimum distribution for 2014, which is due by December 31, 2014, would be $9,623 ($255,000 ÷ 25.6). Receiving a distribution of more than the required minimum will not reduce the amount Ms. Getman is required to take in a subsequent year.[6]

1. Treas. Reg. §1.408-8, A-3.
2. Treas. Reg. §1.401(a)(9)-9, A-2.
3. Treas. Reg. §1.401(a)(9)-5, A-4.
4. Treas. Reg. §1.401(a)(9)-5, A-1(b).
5. Treas. Reg. §1.408-8, A-6.
6. Treas. Regs. §§1.408-8, A-6, 1.401(a)(9)-5, A-3.

Spouse Beneficiary

If the IRA owner's spouse is the only designated beneficiary of the owner's entire interest at all times during the distribution year, the owner may receive distributions over the longer of the distribution period determined from the Uniform Lifetime Table or the joint and survivor life expectancy of the owner and spouse.[1] The joint and survivor life expectancy will provide a longer payout period only if the spouse is more than ten years younger than the IRA owner. For details on the definition of "designated beneficiary," see Q 3645.

Charitable IRA Rollover

For tax years beginning in 2006 through 2013, an IRA owner's required minimum distribution could be reduced, within limits, by the amount of a qualified charitable distribution of up to $100,000, transferred directly from the taxpayer's IRA to a qualified charity.[2] This provision did not apply to SEP IRAs or SIMPLE IRAs (Q 3881). As of the date of this publication, Congress has not taken action to extend this treatment. Absent Congressional action to extend this provision retroactively, the special treatment of charitable distributions made directly from an IRA expired at the end of 2013.

Distributions as Annuity Payments

IRA-required minimum distributions that are made as annuity payments are calculated in the same manner as required minimum distributions from defined benefit plans (Q 3805).[3]

3638. How are the minimum distribution requirements met after the death of an IRA owner?

The minimum distribution requirements that apply after the death of an IRA owner depend on whether the IRA owner died before (see Q 3639) or after (see Q 3640his or her required beginning date.

Distributions generally are treated as having begun in accordance with the minimum distribution requirements under IRC Section 401(a)(9)(A)(ii). If distributions irrevocably (except for acceleration) began prior to the required beginning date in the form of an annuity that meets the minimum distribution rules, the annuity starting date will be treated as the required beginning date for purposes of calculating lifetime and after death minimum distribution requirements.[4]

3639. How are the minimum distribution requirements met when of an IRA owner dies before his required beginning date?

If an IRA owner dies before his or her required beginning date, distributions must be made under either a life expectancy method or the five year rule.[5] After-death distributions from a

1. Treas. Reg. §1.401(a)(9)-5, A-4(b).
2. IRC Sec. 408(d)(8).
3. Treas. Regs. §§1.408-8, A-1, 1.401(a)(9)-6.
4. Treas. Reg. §1.401(a)(9)-6, A-10; Treas. Reg. §1.408-8, A-1.
5. Treas. Reg. §1.401(a)(9)-3, A-1(a).

Roth IRA will be determined under these rules because the Roth IRA owner is treated as having died before his or her required beginning date.[1]

Life Expectancy Method:

Under the life expectancy rule, if any portion of the interest is payable to, or for the benefit of, a designated beneficiary, that portion must be distributed over the life (or life expectancy) of the designated beneficiary (Q 3645)[2] To the extent that the interest is payable to a nonspouse beneficiary, distributions must begin by December 31 of the calendar year immediately following the year in which the IRA owner died.[3] The nonspouse beneficiary's life expectancy for this purpose is measured as of his or her birthday in the year following the year of the owner's death and is determined using the Single Life Table (see Appendix F).[4] In subsequent years, this amount is reduced by one for each calendar year that has elapsed since the year of the owner's death.[5] After the death of a non-spouse beneficiary, the payout period to the successor beneficiary will determined using the deceased beneficiary's remaining life expectancy (based on the age of the beneficiary in the calendar year of death) reduced by one for each calendar year that elapses thereafter.[6]

For the treatment of multiple beneficiaries, see Q 3645.

A surviving spouse who is the sole designated beneficiary of an IRA generally may elect to treat the IRA as his or her own (see Q 3641). Unless this election is made, distributions to a surviving spouse beneficiary must begin by the later of the end of the calendar year immediately following the calendar year in which the owner died, or the end of the calendar year in which the owner would have reached age 70½.[7] The payout period is the surviving spouse's life expectancy, based on his or her attained age in each calendar year for which a minimum distribution is required.[8] After the surviving spouse dies, the payout period is that spouse's remaining life expectancy, based on the age of the spouse in the calendar year of death, reduced by one for each calendar year that elapses thereafter.[9]

Planning Point: The term "stretch IRA" does not appear in the Internal Revenue Code, but simply describes, in popular usage, the practice of IRA distribution planning that successfully permits the beneficiaries (e.g., a surviving spouse and a child of the owner) to receive distributions over their individual life expectancies under the foregoing rules, and satisfy the requirements for separate accounts (Q 3645). A younger beneficiary allows for greater stretching.

A designated beneficiary who does not elect the 5 year method but fails to timely start distributions under the life expectancy method may be able to make up the missed RMDs and pay the 50 percent penalty on the missed distributions, rather than receive the entire balance within 5 years.[10]

1. Treas. Reg. 1.408A-6, A-14(b).
2. IRC Sec. 401(a)(9)(B)(iii), Treas. Reg. §1.401(a)(9)-3, A-1(a).
3. Treas. Reg. §1.401(a)(9)-3, A-3.
4. Treas. Reg. §1.401(a)(9)-9.
5. Treas. Reg. §1.401(a)(9)-5, A-5(c)(1).
6. Treas. Reg. §1.401(a)(9)-5, A-7(c)(2).
7. IRC Sec. 401(a)(9)(B)(iv); Treas. Reg. §1.401(a)(9)-3, A-3.
8. Treas. Reg. §1.401(a)(9)-5, A-5(c)(2).
9. Treas. Reg. §1.401(a)(9)-5, A-5(c)(2).
10. Let. Rul. 200811028.

5 Year Method:

Under the five year rule, the entire interest must be distributed within five years after the death of the IRA owner (regardless of who or what entity receives the distribution).[1] To satisfy this rule, the entire interest must be distributed by the end of the calendar year that contains the fifth anniversary of the date of the IRA owner's death.[2]

Planning Point: The five year period is expanded to six years if 2009 is one of the five years.[3]

Tables contain single and joint and survivor life expectancies for calculating required minimum distributions, as well as a "Uniform Lifetime Table" for determining the appropriate distribution periods.[4] See Appendix F for details.

3640. How are the minimum distribution requirements met when an IRA owner dies on or after the required beginning date?

If the owner of an IRA dies on or after the date distributions have begun (i.e., the required beginning date), but before his or her entire interest in the IRA has been distributed, the entire remaining balance generally must be distributed at least as rapidly as under the method of distribution in effect at the owner's date of death.[5]

If the IRA owner does not have a designated beneficiary as of the date on which the designated beneficiary is determined (the "determination date;" i.e., September 30th of the year after death, see Q 3645), the IRA owner's interest is distributed over his or her remaining life expectancy, using the age of the owner in the calendar year of his or her death, reduced by one for each calendar year that elapses thereafter.[6]

If the owner does have a designated beneficiary as of the determination date, the beneficiary's interest is distributed over the longer of (1) the beneficiary's life expectancy, calculated as described under the "Life Expectancy Method," in Q 3639 or (2) the remaining life expectancy of the owner, determined using the age of the owner in the calendar year of his or her death, reduced by one for each calendar year that elapses thereafter.[7]

For the treatment of multiple beneficiaries and separate accounts, see Q 3645.

Planning Point: The term "stretch IRA" does not appear in the Internal Revenue Code, but simply describes, in popular usage, the practice of IRA distribution planning that successfully permits the beneficiaries (e.g., a surviving spouse and a child of the owner) to receive distributions over their individual life expectancies under the foregoing rules, and satisfy the requirements for separate accounts (Q 3645). A younger beneficiary allows for greater stretching.

1. IRC Sec. 401(a)(9)(B)(ii); Treas. Reg. §1.401(a)(9)-3, A-1(a).
2. Treas. Reg. §1.401(a)(9)-3, A-2.
3. IRC Sec. 401(a)(9)(H)(ii).
4. Treas. Reg. §1.401(a)(9)-9.
5. IRC Sec. 401(a)(9)(B)(i).
6. Treas. Reg. §1.401(a)(9)-5, A-5(c)(3).
7. Treas. Reg. §1.401(a)(9)-5, A-5(c)(3); Treas. Reg. §1.401(a)(9)-5, A-5(a)(1).

3641. What distribution requirements apply to an IRA that is inherited by a surviving spouse?

While a surviving spouse may elect to treat an inherited IRA in the same manner as a non-spousal beneficiary (see Q 3642), a surviving spouse of an IRA owner who is the sole beneficiary of an IRA and who has an unlimited right to make withdrawals from the IRA may also elect to treat the entire account as his or her own IRA. This election can be made at any time after the IRA owner's death.[1]

Any minimum distribution that was required to be made to the deceased owner, but had not been made before the owner's death, must be made to the surviving spouse in the year of death, but in all other respects, required distributions after the owner's death are determined as if the surviving spouse were the owner.[2]

The surviving spouse will be deemed to have made the election to treat the IRA as his or her own if any required amounts in the account have not been distributed under the requirements for after-death required minimum distributions, or any additional amounts are contributed to the account or to an account or annuity to which the surviving spouse has rolled over the amounts.[3]

The result of a surviving spouse making the election to treat an IRA as his or her own is that the surviving spouse then will be considered the IRA owner for all other income tax purposes (for example, for purposes of the 10 percent penalty on early distributions).[4]

In the event that a surviving spouse beneficiary dies after the IRA owner, but before distributions to the spouse have begun, the five-year rule and the life expectancy rule described above will be applied as though the surviving spouse were the IRA owner.[5] As a result, the distribution period is determined by the life expectancy of the surviving spouse's designated beneficiary, determined as of September 30 of the year after the surviving spouse's death.[6] This provision does not allow a new spouse of the deceased IRA owner's surviving spouse to delay distributions under the surviving spouse rules of IRC 401(a)(9)(B)(iv).[7]

Planning Point: The term "stretch IRA" does not appear in the Internal Revenue Code, but simply describes, in popular usage, the practice of IRA distribution planning that successfully permits the beneficiaries (e.g. a surviving spouse and a child of the owner) to receive distributions over their individual life expectancies under the foregoing rules, and satisfy the requirements for separate accounts (Q 3646). A younger beneficiary allows for greater stretching.

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1. Treas. Reg. §1.408-8, A-5(a).
2. Treas. Reg. §1.408-8, A-5(a).
3. Treas. Reg. §1.408-8, A-5(b).
4. Treas. Reg. §1.408-8, A-5(c); see *Gee v. Comm.*, 127 TC 1 (2006).
5. IRC Sec. 401(a)(9)(B)(iv)(II); Treas. Reg. §1.401(a)(9)-4, A-4(b); see Let. Rul. 200436017.
6. Treas. Reg. 1.401(a)(9)-4, A-4(b).
7. Treas. Reg. 1.401(a)(9)-4, A-4(b).

3642. What distribution requirements apply to an inherited IRA where the beneficiary is not the surviving spouse?

If an IRA owner dies before the required beginning date, distributions must be made under either a life expectancy method or the five-year rule.[1] After-death distributions from a Roth IRA will be determined under these rules because the Roth IRA owner is treated as having died before his or her required beginning date.[2]

Under the life expectancy rule, if any portion of the interest is payable to, or for the benefit of, a designated beneficiary, that portion must be distributed over the life (or life expectancy) of the designated beneficiary, beginning within one year of the owner's death.[3] To the extent that the interest is payable to a non-spouse beneficiary, distributions must begin by the end of the calendar year immediately following the calendar year in which the IRA owner died.[4] The non-spouse beneficiary's life expectancy for this purpose is measured as of his or her birthday in the year following the year of the owner's death. In subsequent years, this amount is reduced by one for each calendar year that has elapsed since the year of the owner's death.[5]

A person who wishes to use the life expectancy method and fails to timely start distributions may be able to make up the missed RMDs and pay the 50 percent penalty on the missed distributions.[6]

Under the five-year rule, the entire interest must be distributed within five years after the death of the IRA owner (regardless of who or what entity receives the distribution).[7] To satisfy this rule, the entire interest must be distributed by the end of the calendar year that contains the fifth anniversary of the date of the IRA owner's death.[8]

If the owner of an IRA dies on or after the date distributions have begun (i.e., generally his or her required beginning date), but before the entire interest in the IRA has been distributed, the entire remaining balance generally must be distributed at least as rapidly as under the method of distribution in effect as of the owner's date of death.[9]

If the IRA owner does not have a designated beneficiary as of the date on which the designated beneficiary is determined (i.e., September 30 of the year after death) the IRA owner's interest is distributed over his or her remaining life expectancy, using the age of the owner in the calendar year of his or her death, reduced by one for each calendar year that elapses thereafter.[10]

If the owner does have a designated beneficiary as of the determination date, the beneficiary's interest is distributed over the longer of (1) the beneficiary's life expectancy, calculated

1. Treas. Reg. §1.401(a)(9)-3, A-1(a).
2. Treas. Reg. §1.408A-6, A-14(b).
3. IRC Sec. 401(a)(9)(B)(iii), Treas. Reg. §1.401(a)(9)-3, A-1(a).
4. Treas. Reg. §1.401(a)(9)-3, A-3.
5. Treas. Reg. §1.401(a)(9)-5, A-5(c)(1).
6. Let. Rul. 200811028.
7. IRC Sec. 401(a)(9)(B)(ii); Treas. Reg. §1.401(a)(9)-3, A-1(a).
8. Treas. Reg. §1.401(a)(9)-3, A-2.
9. IRC Sec. 401(a)(9)(B)(i).
10. Treas. Reg. §1.401(a)(9)-5, A-5(c)(3).

as described above at "Life Expectancy Rule,"[1] or (2) the remaining life expectancy of the owner, determined using the age of the owner in the calendar year of his or her death, reduced by one for each calendar year that elapses thereafter.[2]

See Q 3641 for the treatment of an IRA that is inherited by a surviving spouse.

3643. Can the beneficiary of an inherited IRA roll funds from a separate retirement account into the inherited IRA?

Yes. Beginning for distributions in 2008, a non-spouse beneficiary of a qualified plan, a tax sheltered annuity, or an eligible Section 457 governmental plan may make a direct rollover into an inherited IRA, including a Roth IRA.[3] The rollover must be made by means of a trustee-to-trustee transfer. The transfer will be treated as an eligible rollover distribution.[4] Distributions to non-spouse beneficiaries prior to 2008 were not eligible rollover distributions.

An inherited IRA created under this provision must remain in the name of the owner of the original retirement account payable to the designated beneficiary. The IRA is subject to required minimum distributions as for any inherited IRA payable to a designated beneficiary (see Q 3641 and Q 3642).

Because the surviving spouse of an owner of a traditional IRA is not subject to the inherited IRA rules (since the surviving spouse may treat the inherited IRA as though it was his or her own IRA, see Q 3641), the surviving spouse may make rollovers to and from the plan.[5] This generally has held true whether the spouse was the beneficiary designated under the plan or inherited the account as sole beneficiary of the owner's estate.[6]

3644. Are inherited IRA funds exempt from the claims of a taxpayer's creditors in bankruptcy?

Whether or not the funds in an inherited IRA are exempt from the claims of a taxpayer's creditors in bankruptcy has been an issue that many have disagreed upon in past years, but that the Supreme Court resolved in 2014.[7] Under current law, therefore, the funds in an inherited IRA are subject to the claims of a debtor's creditor in bankruptcy *if* the account is inherited by a beneficiary *who is not the original account owner's surviving spouse*.

Traditional and Roth IRAs that are not inherited accounts are typically exempt from bankruptcy claims up to an inflation-adjusted $1 million limit (in 2014, the amount is $1,245,475).[8]

Prior to the Supreme Court's review of the issue, in some jurisdictions (the Eighth Circuit, for example), inherited IRAs were exempt from bankruptcy claims based on the premise that

1. Treas. Reg. §1.401(a)(9)-5, A-5(c)(1), (2).
2. Treas. Regs. §§1.401(a)(9)-5, A-5(c)(3); 1.401(a)(9)-5, A-5(a)(1).
3. Notice 2008-30, 2008-1 CB 638, A-7.
4. IRC Sec. 402(c)(11).
5. IRC Sec. 408(d)(3)(C).
6. Let. Ruls. 9820010, 9502042, 9402023, 8925048.
7. *Clark v. Rameker*, 134 S. Ct. 2242 (2014).
8. 11 U.S.C. §522.

the funds are retirement funds contained in otherwise tax-exempt vehicles. However, other courts had held that inherited IRAs lack the requisite retirement purpose. The rationale behind this line of decisions (most prominently found in the Seventh Circuit) was that inherited IRAs are subject to an entirely different set of rules than IRAs held by their original owners.

Importantly, while a penalty is imposed on any non-inherited IRA funds that are withdrawn by the owner prior to a certain age, inherited IRA assets are liquid assets that can be accessed by the beneficiary at any time and without penalty. Further, the rules actually require that the inherited IRA funds be withdrawn within a relatively short time frame (either within five years or over the beneficiary's life expectancy, see Q 3641 and Q 3642) set without regard to the typical retirement age.

This split among the circuits prompted the Supreme Court's recent review of the issue. Though the rule is not settled with respect to *non-spouse* beneficiaries, taxpayers should note that the Supreme Court decision did not address the issue of IRAs that are inherited by a surviving spouse (see Q 3641).

3645. Who is a "designated beneficiary" for purposes of required minimum distributions from an IRA?

A designated beneficiary is an individual (or a trust meeting certain requirements, see Q 3809) designated as a beneficiary, either by the terms of the IRA document, by an affirmative election by the IRA owner, or by a surviving spouse.[1] For lifetime distributions, the identity and age of the designated beneficiary do not affect the IRA owner's distributions unless the sole designated beneficiary is a spouse more than ten years younger than the owner (Q 3637).

The designated beneficiary need not be specified by name to be a designated beneficiary so long as he or she is identifiable under the terms of the IRA as of the determination date.[2] For special rules governing contingent and successor beneficiaries, see Q 3809.

For purposes of after-death minimum distribution requirements, the final regulations require that a beneficiary determination be made as of September 30 of the year after the year of the IRA owner's death.[3] This date is designed to provide ample time following the determination of the designated beneficiary(ies) to calculate and make the required distribution prior to the distribution deadline (i.e. the end of the calendar year following the owner's death.[4] (Exceptions to the September 30 deadline may apply if the account is payable as an annuity, or if a surviving spouse beneficiary dies after the IRA owner but before distributions have begun). Consequently, an individual who was a beneficiary as of the date of the owner's death, but who is not a beneficiary as of September 30 of the following year (e.g., because the individual disclaims entitlement to the benefit or because the individual receives the entire benefit to which he or she is entitled before that date) is not taken into account for purposes of determining the distribution period for required minimum distributions after the owner's death.[5]

1. Treas. Reg. §1.401(a)(9)-4, A-1.
2. Treas. Reg. §1.401(a)(9)-4, A-1.
3. Treas. Reg. §1.401(a)(9)-4, A-4(a).
4. Treas. Reg. §1.401(a)(9)-3, A-3(a).
5. Treas. Reg. §1.401(a)(9)-4, A-4(a).

A disclaiming beneficiary's receipt of a required distribution, prior to disclaiming the benefit, in the year after death will not result in the beneficiary being treated as a designated beneficiary for subsequent years.[1] In a private letter ruling, the IRS also determined that a post-death reformation of a beneficiary designation form that had inadvertently excluded a decedent's children was effective to create a "designated beneficiary."[2] The children had been omitted as contingent beneficiaries on their father's beneficiary designation due to a mistake by a bank employee, and not due to their fault. The children were therefore allowed to set up inherited IRAs after their father's death.

If a beneficiary is not an individual or a permitted trust, the IRA owner will be treated as having no beneficiary and the 5 year rule will apply (Q 3639). An IRA owner's estate may not be a designated beneficiary.[3]

As a general rule, only an individual (not an estate or a trust) may be a designated beneficiary for required minimum distribution purposes. If the special requirements for a "see-through" trust are met (Q 3809), however, the beneficiaries of a trust may be treated as if they had been designated as the beneficiaries of the IRA for required minimum distribution purposes (but not for purposes of "separate account treatment," see Q 3646).

3646. What are the rules for determining required minimum distributions when there are multiple beneficiaries and separate accounts?

If more than one beneficiary is designated as of the date on which the determination is made (Q 3645), the beneficiary with the shortest life expectancy (i.e., generally the oldest) will be the designated beneficiary for purposes of determining the distribution period.[4]

As an exception to the "oldest beneficiary" rule, if an individual account (including an IRA)[5] is divided into separate accounts (as defined below) with different beneficiaries, the separate accounts do not have to be aggregated for purposes of determining the required minimum distributions for years subsequent to the calendar year in which the separate accounts were established (or date of death, if later).[6]

For purposes of Section 401(a)(9), "separate accounts" are portions of an employee's benefit (or IRA) representing the separate interests of the employee's beneficiaries under the plan as of his date of death. The separate accounting must allocate all post-death investment gains and losses, contributions, and forfeitures for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner among the accounts. Once separate accounts are actually established, the separate accounting can provide for separate investments in each account, with gains and losses attributable to such investments allocable only to that account. A separate accounting also must allocate any post-death distribution to the separate account of the beneficiary receiving it.[7]

1. Rev. Rul. 2005-36, 2005-1 CB 1368.
2. Let. Rul. 200616039.
3. Treas. Reg. §1.401(a)(9)-4, A-3.
4. Treas. Reg. §1.401(a)(9)-5, A-7(a).
5. Treas. Reg. §1.408-8, A-1(a).
6. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).
7. Treas. Reg. §1.401(a)(9)-8, A-3.

Planning Point: When leaving an IRA to multiple beneficiaries, an owner may leave a fixed dollar ("pecuniary") amount to one or more of them, with a "residual" gift to one or more other beneficiaries, or use "fractional"-type gifts for all beneficiaries. Although both methods are legal and acceptable, fractional gifts usually are preferable, for two reasons.

First, if the owner uses a pecuniary gift (such as "pay $10,000 to Beneficiary A and the balance of the account to Beneficiary B"), the IRA provider may not know whether to give the "pecuniary" beneficiary just the flat dollar amount or to give that beneficiary the dollar amount plus or minus gains or losses that accrue after the date of death. The IRA provider's documents and policies should spell this out, but many do not.

Second, if the gift is truly a flat dollar amount, not adjusted for gains or losses occurring after the date of death, then that gift cannot qualify under the regulations as a "separate account" (see above) for minimum distribution purposes. Thus, the beneficiary of the flat dollar gift and the beneficiaries of the "residuary" gift will be considered beneficiaries of the same account. This means that, unless the pecuniary beneficiary's share is distributed (or disclaimed) in full prior to September 30 of the year after the year of death, the residuary share beneficiaries will not be able to use the life expectancy payout method if the pecuniary beneficiary is a charity (a non-individual). *Natalie B. Choate, Esq., Bingham McCutchen.*

When separate accounts are established with different beneficiaries, the "applicable distribution period" is determined for each separate account disregarding the other beneficiaries only if the separate account is established no later than December 31 of the year following the decedent's death.[1] If this deadline is not met, separate accounts can be established at any time, but the distribution period in effect prior to the separation of the accounts (generally the life expectancy of the oldest beneficiary) will continue to be applied.[2]

Planning Point: If the foregoing requirements are not met (i.e., if separate accounts are not established by the deadline or to the extent the IRA proceeds were payable to one trust benefiting more than one individual), the IRA nonetheless may be segregated into separate IRA accounts, but the "applicable distribution period" will be the life expectancy of the beneficiary with the shortest life expectancy.[3]

If a trust is the beneficiary, separate account treatment is not available to the beneficiaries of the trust.[4] The IRS has determined repeatedly that the establishment of separate IRA shares (i.e., creating separate IRAs titled in the name of the decedent for the benefit of the trust beneficiaries) did not entitle multiple beneficiaries of the same trust to use their own life expectancies as the distribution period.[5] Where the trust established by the decedent to receive IRA proceeds included provisions for a subtrust benefiting the surviving spouse, the surviving spouse's life expectancy was found to be controlling for all beneficiaries.[6] In another instance, the IRS determined that where a father had failed to designate an IRA beneficiary, making his estate, which was left to his three children, the beneficiary, the decedent's remaining life expectancy was controlling, although a subdivision of the IRA was permitted.[7] The fact that the trust meets the requirements for a "see-through trust" (Q 3809) does not change this result.[8]

1. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).
2. TD 8987, 67 Fed. Reg. 18988 (4-17-02).
3. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).
4. Treas. Reg. §1.401(a)(9)-4, A-5(c).
5. Let. Ruls. 200307095, 200317043, 200444033, 200432027, 200528031.
6. Let. Ruls. 200410019, 200438044.
7. Let. Rul. 200343030.
8. Let. Rul. 200317044.

The IRS has privately ruled, however, that where separate individual trusts were named as beneficiaries, the ability of each beneficiary to use his or her life expectancy was preserved even though the trusts were governed by a single "master trust."[1]

For details regarding contingent and successor beneficiaries, as well as other special rules, see Q 3809.

3647. What are an IRA trustee's reporting requirements with respect to required minimum distributions?

Two reporting requirements are imposed on IRA trustees: one to the IRA owner, and one to the IRS.[2] For IRA owners, "[i]f a minimum distribution is required with respect to an IRA for a calendar year and the IRA owner is alive at the beginning of the year, the trustee that held the IRA as of December 31 of the prior year must provide a statement to the IRA owner by January 31 of the calendar year."The statement must satisfy one of the following alternatives:

(1) It must inform the IRA owner of the amount of the required minimum distribution and the date by which it is required. The amount is permitted to be calculated assuming that the sole beneficiary of the IRA is not a spouse more than ten years younger than the IRA owner, and that no amounts received by the IRA after December 31 of the prior year are required to be taken into account to adjust the value of the IRA as of December 31 of the prior year for purposes of determining the required minimum distribution;[3] or

(2) It must inform the IRA owner that a minimum distribution is required with respect to the IRA, and offer to calculate the amount of the distribution on request by the owner.[4]

The IRS has clarified that a trustee may use either of these two alternatives, or may use one alternative for some IRA owners and the other for other IRA owners.[5]

The reporting requirements apply only to lifetime distributions. The IRA owner is presumed not to have a spouse more than ten years younger than the owner.[6]

No reporting is required for after death distributions (i.e. inherited IRAs) or for Roth IRAs.[7]

3648. What IRS filing requirements does an individual retirement plan participant have to meet?

An individual who establishes an individual retirement does not have a filing requirement (other than what is reported on the individual's 1040) for any year in which there is no plan

1. Let. Rul. 200537044.
2. Notice 2002-27, 2002-1 CB 814.
3. See Q&A-7 or Q&A-8 of Treas. Reg. §1.408-8.
4. Notice 2002-27.
5. Notice 2003-3, 2003-1 CB 258, Notice 2009-9, 2009-5 IRB.
6. Notice 2002-27, 2002-1 CB 814.
7. Notice 2002-27.

activity other than a re-characterization or the making of contributions (other than rollover contributions) and permissible distributions. However, an individual does need to file a separate return (Form 5329) if there is any tax due because of an early (premature) distribution (Q 3629), excess contribution (Q 3623), or excess accumulation (Q 3634).[1]

Nondeductible Contributions

If an individual makes a nondeductible contribution to a traditional IRA for any year, the individual must report the following on Form 8606.

(1) The amount of the nondeductible contributions for the taxable year

(2) The amount of distributions from individual retirement plans for the taxable year

(3) The excess of the aggregate amount of nondeductible contributions for all preceding years over the aggregate amount of distributions that were excludable from income for such taxable years

(4) The aggregate balance of all individual retirement plans as of the close of the year in which the taxable year begins

(5) The amount of a traditional IRA that is converted into and recharacterized as a Roth IRA, or the amount in the same Roth IRA that is then converted back into and recharacterized as a traditional IRA

(6) Any other information as prescribed by the Secretary of the Treasury.[2]

Failure to file Form 8606 will result in a $50 penalty per failure unless it is shown that the failure was due to reasonable cause.[3] In one case, a failure to file a Form 8606 resulted in the taxpayer's failure to appropriately document his basis in his nondeductible IRA; contributions were taxed a second time on distribution (Q 3625).[4] Overstatement of a nondeductible contribution is subject to a penalty tax of $100 per occurrence.[5]

3649. May an employer contribute to an IRA on behalf of an employee? May an employer or union establish an IRA for its employees or members?

Yes.

An employer may contribute to a traditional or Roth IRA on behalf of any eligible employee (or an eligible spouse as described in Q 3612). Any contribution made by the employer must be included in the employee's gross income as compensation for the year for which the contribution was made.[6] The employer's contribution is treated as though made by the employee and subject to the maximum contribution limits applicable to individual retirement plans (Q

1. IRC Secs. 6058(d), 6058(e).
2. IRC Sec. 408(o).
3. IRC Sec. 6693(b)(2).
4. *Alpern v. Comm.*, TC Memo 2000-246.
5. IRC Sec. 6693(b)(1).
6. IRC Sec. 219(f)(5); see Prop. Treas. Reg. §1.219(a)-2(c)(4).

3614, Q 3615). If the contribution is made to a traditional IRA and the employee is eligible, the employee may take a deduction subject to the limits in Q 3614. The employer deducts the contribution as salary or other compensation and not as a contribution to a retirement plan.[1] Because amounts contributed by an employer are compensation to the employee, they are subject to FICA (Social Security tax), FUTA (federal unemployment tax), and income tax withholding.[2]

A trust that will be treated as an individual retirement account may be set up by an employer or association of employees for the benefit of employees, members, or employees of members (or the eligible spouses of any of the foregoing) if the trust meets all the requirements of an IRA (Q 3602) and there is a separate accounting maintained for each employee, member, or spouse. A contribution made by an employer to a trust on behalf of an employee will be treated as a contribution to an individual retirement plan by such employee. The assets of an employer or association trust may be held in a common fund for the account of all individuals who have an interest in the trust. A trust may include amounts held for former employees or members and employees temporarily on leave. To qualify as an "association of employees" there must initially have been some nexus between the employees (e.g., a common employer, a common industry, etc.). An association may include members who are self-employed.[3]

Employer contributions to an individual retirement plan (or employer or association trust that is treated as an individual retirement account) are not required to meet any nondiscrimination rules. An employer generally cannot satisfy the coverage requirement for a qualified plan by contributing to an individual retirement account (including an employer or association trust treated as an individual retirement account) or individual retirement annuity on behalf of employees not covered under the qualified plan.[4]

The use of a payroll deduction program to fund employee IRAs will not subject the employer to Title I of ERISA (reporting and disclosure, participation, and vesting, etc.) where employer involvement is limited. The employer's involvement is so limited where the employer maintains neutrality with respect to an IRA sponsor in its communications with its employees and so is not considered to have "endorsed" an IRA payroll deduction program. The employer must also make clear that its involvement in the program is limited to collecting the deducted amounts and remitting them promptly to the IRA sponsor, and that it does not provide any additional benefit or promise any particular investment return on the employee's savings.[5]

An employer also may establish "deemed IRAs" for employees under a qualified plan (Q 3605). An employer may contribute amounts higher than the usual individual retirement plan limits by establishing a simplified employee pension program (Q 3650) or a SIMPLE IRA (see Q 3654).

1. IRC Sec. 162; Prop. Treas. Reg. §1.219-1(c)(4).
2. H. R. Conf. Rep. 93-1280 (ERISA '74) *reprinted in* 1974-3 CB 500; H. Rep. 93-807, *reprinted in* 1974-3 Supp. CB 367; IRC Sec. 3401(a)(12)(C).
3. IRC Sec. 408(c); Treas. Reg. §1.408-2(c).
4. H. R. Conf. Rep. 93-1280 (ERISA '74) *reprinted in* 1974-3 CB 499.
5. Labor Reg. §2510.3-2(d); see IB 99-1, 64 Fed. Reg. 32999 (6-18-99).

3650. What is a simplified employee pension?

A simplified employee pension (SEP) is a traditional individual retirement account or individual retirement annuity (Q 3602) that is adopted by a business to provide retirement benefits for the business owners and employees and may accept an expanded rate of contributions over traditional IRAs.[1] The SEP IRA is owned by the employee.

The SEP rules permit an employer to contribute a limited amount of money each year on behalf of its employees. A self-employed individual may contribute to his/her own SEP. All contributions must be in the form of money; property canont be contributed. Although contributions are not required every year, any contributions made by an employer in a given year must be based on a written formula and must not discriminate in favor of highly-compensated employees.

More specifically, in order for an IRA to qualify as a SEP, certain requirements must be satisfied:

(1) **Participation:** The employer must contribute to the SEP of each employee (including certain "leased" employees, see Q 3826) who is at least 21 years old, has performed services for the employer during the year for which the contribution is made (including any such employee who, because of death or termination of employment, is no longer employed on the date contributions are actually made), *and* for at least three of the immediately preceding five years has received at least $550 in compensation (in 2010-2014) from the employer for the year.[2] (See Appendix E for earlier years.) This includes employees over age 70½, who are subject to the minimum distribution requirements (Q 3637). The employer may not require that an employee be employed as of a particular date in the year.[3]

Employees covered by a collective bargaining agreement may be excluded from participation if retirement benefits have been the subject of good faith bargaining. Similarly, nonresident aliens may be excluded if they received no income from the employer that is considered to be from U.S. sources.[4]

(2) **Non-discrimination requirement:** Employer contributions must not discriminate in favor of any highly compensated employee (Q 3827). Employees who are excluded from participation as nonresident aliens, or because they are covered by a collective bargaining agreement, are not considered for purposes of determining whether there is discrimination.[5]

Unless employer contributions bear a uniform relationship to total compensation (or earned income in the case of self-employed individuals) they will be discriminatory. But compensation or earned income in excess of $260,000 (in

1. IRC Sec. 408(k).
2. IRC Sec. 408(k)(2)(C); IR-2009-94.
3. Prop. Treas. Reg. §1.408-7(d)(3).
4. IRC Sec. 408(k)(2).
5. IRC Sec. 408(k)(3).

2014) is not to be taken into account.[1] This compensation limit is indexed for inflation. (See Appendix E for the indexed amounts for earlier years.)[2] Presumably, a constant percentage of compensation would meet the nondiscrimination requirement. A rate of contribution that decreases as compensation increases will be considered uniform.[3] The IRS has informally approved a method of contribution that in effect required that an identical dollar amount be contributed on behalf of all participants.[4]

SEPs can be integrated under the rules applicable to qualified plans (Q 3779).[5]

(3) **Contributions Based on Written Allocation Formula:** Employer contributions must be determined under a definite written allocation formula that specifies the manner in which the allocation is computed and what requirements an employee must satisfy to share in the allocation. But the employer may vary the allocation formula from year to year so long as there is a timely amendment to the plan that indicates the new formula.[6] No minimum funding standards are imposed.

Planning Point: The allocation formula may be written to provide that contributions be based on a fixed percentage of the employee's compensation, a fixed dollar amount for all participants, or that contributions be determined each year by the employer (a discretionary contribution). Discretionary contribution formulas are the most common. The employer may uniformly vary the percentage of compensation contributed year by year or contribute nothing for a particular year, but the SEP document must state how the employer contribution will be allocated. An employer may vary the formula or percentage from year to year (for example, to change from a fixed contribution to a discretionary contribution), provided the SEP is timely amended.[7]

(4) **No Withdrawal Restrictions:** The employer contribution may not be conditioned on the employee's keeping any part of it in the pension and the employer may not prohibit withdrawals from the plan.[8]

(5) **Top Heavy Plans:** If the SEP is top-heavy plan (Q 3818), it is subject to the minimum contribution rules applicable to such plans (Q 3823).[9] Employer contributions to a SEP may be taken into account in determining whether qualified plans of the employer are top-heavy (Q 3818)

Should an eligible employee or former employee not have an IRA on the date contributions are made, the employer is required to establish one on the employee's behalf.[10] A SEP plan need not be established until the contribution is made for the year (i.e., it may be established after the end of the year — see Q 3652).

1. IRC Sec. 408(k)(3)(C); IR-2013-86.
2. IRC Secs. 408(k)(8), 401(a)(17).
3. Prop. Treas. Reg. §1.408-8(c).
4. See Let. Rul. 8824019.
5. IRC Sec. 408(k)(3)(D); TAMRA '88, Sec. 1011(f)(7).
6. Prop. Treas. Reg. §1.408-7(e).
7. IRS Examining Process Guide (Chapter 72, Section 17).
8. IRC Sec. 408(k)(4).
9. IRC Secs. 408(k)(1)(B), 416(c)(2).
10. See Prop. Treas. Reg. §1.408-7(d)(2).

A controlled group of corporations or employers under common control or employers composing an "affiliated service group" (Q 3830, Q 3832) are treated as a single employer. Thus, if contributions are made to SEPs for employees in one business, they may have to be made for employees of another business if the two are under common control or constitute an affiliated service group.[1]

SEPs are treated as defined contribution plans for purposes of the overall limits on employer contributions (Q 3784).[2] For plan years beginning in 2014, the annual additions limit for defined contribution plans as a whole is the lesser of $52,000 ($51,000 for 2013, see Appendix E for earlier years) or 100 percent of compensation.[3] Any contribution *by an employer* to a SEP must be aggregated with all other employer contributions by that employer to defined contribution plans for purposes of the Section 415(c) limit on annual additions. Catch-up contributions, which are available only in plans that provide for elective deferral contributions (Q 3653, Q 3654, Q 3697), are not available in SEPs but are available in grandfathered (pre-1997) salary reduction SEPs.

3651. What are the contribution limits for a simplified employee pension?

Employee Contributions

An employee may treat his SEP account as a traditional IRA and make deductible or nondeductible contributions to it under the general IRA rules described in Q 3611 to Q 3634. However, any dollars contributed to the SEP will reduce the amount the individual employee can contribute to other IRAs, including Roth IRAs, for the year.

> *Example 1*: Nancy's employer, JJ Handyman, contributes $5,000 to Nancy's SEP-IRA at ABC Investment Co. based on the terms of the JJ Handyman SEP plan. Nancy, age 45, is permitted to make traditional IRA contributions to her SEP-IRA account at ABC Investment Co., and she contributes $3,000 in 2013. If Nancy also wants to contribute to her Roth IRA at XYZ Investment Co. for 2013, she can contribute $2,000 ($5,000 maximum contribution less the $3,000 already contributed to her SEP-IRA) by April 15, 2014.

Salary deferrals are only allowed to Salary Deferral SEPs, known as SAR-SEP, and no new SAR-SEPs are permitted as of 1997 (Q 3653).

Employer Contributions

Contributions made by an employer on behalf of an employee to a SEP are excludable from the employee's income to the extent that they do not exceed *the lesser of* 25 percent of compensation from the employer (determined without regard to that employer's contribution to the SEP) or $52,000 in 2014.[4] Compensation is capped by the limits in effect under IRC Sec 414(s) ($260,000 for 2014) (Q 3783). Despite the $260,000 limit on compensation, the maximum permitted SEP contribution is capped at $52,000 for 2014 (where $52,000 is less than $260,000 × 25 percent).

1. IRC Secs. 414(b), 414(c), 414(m); Let. Rul. 8041045.
2. IRC Sec. 415(a)(2)(C).
3. IRC Sec. 415(c)(2).
4. IRC Secs. 402(h)(2), 415(c)(1)(A); IR-2013-86.

Planning Point: Interestingly, "compensation" is defined for these purposes as amounts actually includible in the employee's gross income; consequently, "elective deferrals" by an employee (i.e. amounts contributed to a qualified retirement plan) would not be considered in the "lesser of" calculation above as compensation.[1] This definition of compensation, however, differs from the definition of compensation used to determine the employer's deduction when contributing to an employee's SEP, which does consider elective deferrals when determining income (Q 3652).

When determining the contribution limits of a "self-employed" individual, "compensation" is the individual's net earnings from self-employment.

If an individual is employed by more than one employer (other than employers who are under common control or compose a controlled or affiliated service group) during the tax year, the 25 percent limit is applied separately to each employer.[2] Under proposed regulations, contributions by (and compensation received from) employers who are under common control or who are members of a controlled group must be aggregated for purposes of this limit.[3] It would seem that the IRS may also require such aggregation where the employers are members of an affiliated service group.

If an individual is self-employed with respect to more than one trade or business, the maximum contribution will be the lesser of the amount determined by applying the limit separately to each trade or business *or* the amount determined by applying the limit as if the trades or businesses constituted one employer.[4] In an integrated plan, the 415 dollar limit must be reduced in the case of a highly compensated employee (Q 3827).[5] Contributions are not subject to income tax withholding, FICA, or FUTA.[6]

3652. Can an employer deduct contributions made to a simplified employee pension?

Employer contributions for a calendar year are deductible, under IRC Section 404, for the tax year in which the calendar year ends. An employer may elect to use its taxable year instead of the calendar year for purposes of determining contributions to a SEP.[7] Employer contributions made on account of a calendar year or an employer's taxable year may be made as late as the due date (plus extensions) of the employer's tax return for such year and be treated as if contributed on the last day of that year.[8] The due date for C corporations is March 15th following the close of such year and for self-employed individuals is April 15th following the close of such year.[9]

The maximum employer deduction amount is 25 percent of compensation for the calendar year (or, if applicable, the taxable year).[10] "Compensation," for this purpose, *includes* elective deferrals and certain other contributions made on a pre-tax basis.[11]

1. IRC Secs 402(h)(2)(B).
2. See IRC Sec. 219(b)(2).
3. See Prop. Treas. Reg. §1.219-3(c).
4. See Prop. Treas. Reg. §1.219-3(c)(2).
5. IRC Sec. 402(h)(2)(B).
6. IRC Secs. 3401(a)(12)(C), 3121(a)(5)(C), 3306(b)(5)(C). See also Rev. Rul. 65-209, 1965-2 CB 414.
7. IRC Sec. 404(h)(1)(A).
8. IRC Sec. 404(h)(1)(B).
9. IRC Secs. 6012(a), 6072.
10. IRC Sec. 404(h)(1)(C).
11. See IRC Sec. 404(a)(12), 404(n).

Contributions in excess of the 25 percent deductible limit may be carried over and deducted in succeeding years.[1] But the employer is subject to an excise tax on nondeductible contributions (Q 3840). If the employer also contributes to a qualified profit sharing or stock bonus plan, the 25 percent deductible limit for that plan is reduced by the amount of the allowable deduction for contributions to the SEPs with respect to participants in the stock bonus or profit sharing plan.[2] If the employer also contributes to any other type of qualified plan, the SEP is treated as a separate profit sharing or stock bonus plan for purposes of applying the combination deduction limit of IRC Section 404(a)(7) (Q 3839).[3]

3653. What is a SAR-SEP? What requirements must be met if a simplified employee pension is offered on cash or deferred basis?

A SAR-SEP is a simplified employee pension that is offered on a salary reduction (i.e., a cash or deferred) basis. In other words, the plan permits individual employees to elect to have contributions made to the SEP or to receive the contribution in cash. A SEP must otherwise meet the requirements in Q 3650, as well as those explained below, and the plan had to be established before 1997. No new SAR-SEPs are permitted after 1996, but those in effect prior to 1997 may continue to operate, receive contributions, and add new employees.[4]

A SAR-SEP may be maintained by an employer who had twenty-five or fewer employees who were eligible to participate in the plan at any time during the prior taxable year. The amount that an employee chooses to defer and contribute to the SEP is referred to as an elective deferral. Elective deferrals (Q 3705) are subject to the same $17,500 cap (in 2013 and 2014, up from $17,000 in 2012) as elective deferrals to IRC Section 401(k) plans.[5] Elective deferrals also are subject to FICA and FUTA withholding.[6] Certain lower income taxpayers may be eligible to claim the saver's credit for elective deferrals to a SAR-SEP (Q 3607).

In addition to the elective deferrals described above, a SAR-SEP may permit additional elective deferrals by individuals age fifty or over, referred to as "catch-up contributions."[7] The dollar limit on catch-up contributions to a SAR-SEP is $5,500 in 2013 and 2014 (see Appendix E for earlier years).[8] For details on the requirements for catch-up contributions, see Q 3706.

Contributions made by an employer on behalf of an employee to a SAR-SEP are excludable from the employee's income to the extent that they do not exceed the lesser of 25 percent of "compensation" from the employer, or $52,000 in 2014 (up from $51,000 in 2013, see Appendix E for earlier years).[9] As a result of an apparent oversight by Congress, compensation, for this purpose only, is includable compensation (i.e., not including elective deferrals).[10]

1. See IRC Sec. 404(h)(1)(C).
2. IRC Sec. 404(h)(2).
3. IRC Sec. 404(h)(3).
4. See IRC Sec. 408(k)(6)(H).
5. IRC Sec. 402(g)(1); IR-2012-77, IR-2013-86.
6. IRC Secs. 3121(a)(5)(C), 3306(b)(5)(C).
7. See IRC Secs. 414(v)(1), 414(v)(6)(A)(iv).
8. IRC Sec. 414(v)(2)(B)(i); IR-2013-86.
9. IRC Secs. 402(h)(2)(A), 415(c)(1)(A); IR-2013-86.
10. See IRC Sec. 402(h)(2)(A).

The election to defer salary into a SAR-SEP account is available only if (1) at least 50 percent of the employees of the employer eligible to participate elect to have amounts contributed to the SEP; and (2) the deferral percentage for each highly compensated eligible employee does not exceed the average deferral percentage for all nonhighly compensated eligible employees multiplied by 125 percent.[1] Catch-up contributions are not taken into account for this purpose.[2] Compensation or earned income in excess of $260,000 (in 2014, up from $255,000 in 2013) is not to be taken into account in determining an employee's deferral percentage.[3] This amount is indexed for inflation. (See Appendix E for the amounts in earlier years.)

A SAR-SEP will not be treated as failing to meet the deferral percentage requirement if, before the end of the following plan year, any excess contribution (i.e., in excess of 125 percent), plus any income attributable to such excess, is distributed or treated as distributed and then contributed by the employee to the plan.[4] Such a recharacterization of contributions is not permitted in the absence of regulations.[5]

Unless the excess is distributed within 2½ months after the end of the plan year, the employer will be subject to a 10 percent excise tax.[6] Any excess amounts so distributed generally are treated as received by the recipient in the taxable year for which the original contribution was made; if total excess contributions distributed to a recipient under the plan for a plan year are less than $100, the distributions will be treated as received in the taxable year of distribution.[7]

Since an employer may not force an employee to take a distribution of excess deferrals because the contributions are held in an individual retirement plan controlled by the employee, the Secretary of Treasury has the authority to prescribe necessary rules to ensure that excess contributions are distributed, including reporting requirements and the requirement that contributions may not be withdrawn until a determination is made that the deferral percentage test has been satisfied.[8] Any distribution or transfer before such a determination has been made will be subject to ordinary income tax as well as to the early distribution penalty, regardless of whether the penalty tax would otherwise apply.[9]

A plan will not be treated as violating any applicable limit of IRC Section 408(k) merely on account of the making of (or right to make) catch-up contributions by participants age fifty or over under the provisions of IRC Section 414(v), so long as a universal availability requirement is met.[10] In addition, catch-up contributions are not taken into account for purposes of the

1. IRC Sec. 408(k)(6).
2. IRC Sec. 414(v)(3)(A).
3. IRC Sec. 408(k)(6)(D); IR-2013-86.
4. IRC Secs. 408(k)(6)(C), 401(k)(8).
5. General Explanation of TRA '86, p. 639.
6. IRC Sec. 4979.
7. IRC Sec. 4979(f)(2).
8. IRC Sec. 408(k)(6)(F).
9. IRC Sec. 408(d)(7).
10. IRC Sec. 414(v)(3)(B).

employer deduction limitation explained in Q 3650.[1] See Q 3706 for details on the requirements for catch-up contributions.

State or local governments and other tax-exempt organizations may not offer SAR-SEPs.[2]

3654. What is a SIMPLE IRA plan?

A SIMPLE (which stands for Savings Incentive Match Plan for Employees) IRA plan is a simplified, tax-favored retirement plan offered by small employers that provides employees with a simplified method to contribute toward their retirement savings. Employees may choose to make salary reduction contributions (aka elective deferrals) and the employer is required to make either matching or nonelective contributions. Contributions are made to an IRA set up for each employee that meets certain vesting, participation, and administrative requirements described below.[3]

A SIMPLE IRA plan may permit contributions only under a *qualified salary reduction arrangement*, which is defined as a written arrangement of an "eligible employer" (defined below) under which:

(1) employees eligible to participate may elect to receive payments in cash or contribute them directly to a SIMPLE IRA per a salary deferral,

(2) the amount to which such an election applies must be expressed as a percentage of compensation and may not exceed $12,000 per year (in 2013 and 2014, up from $11,500 in 2010-2012); but the amount of the contribution may also be expressed as a dollar amount,

(3) the employer must make matching contributions or nonelective contributions to the account according to one of the formulas described in Q 3655, and

(4) no contributions other than those described in (1) and (3) may be made to the account.[4]

Certain lower income taxpayers may be eligible to claim the saver's credit for elective deferrals to a SIMPLE IRA (Q 3607).

Elective Deferral and Catch-up Contributions

The amount contributed via an elective deferral cannot exceed $12,000 for 2013 and 2014.[5] A SIMPLE IRA plan, however, may permit catch-up contributions by participants who reach age 50 (or over) by the end of the plan year.[6] The limit on catch-up contributions to SIMPLE IRAs is the lesser of (a) a specified dollar limit, or (b) the excess (if any) of the participant's

1. IRC Sec. 414(v)(3)(A).
2. IRC Sec. 408(k)(6)(E).
3. IRC Sec. 408(p)(1); Notice 98-4, 1998-1 CB 269; General Explanation of Tax Legislation Enacted in the 104th Congress (JCT-12-96), p. 140 (the "1996 Blue Book").
4. IRC Sec. 408(p)(2); Notice 98-4; IR-2011-103, IR-2013-86.
5. IRC Secs. 408(p)(2)(A)(ii), 408(p)(2)(E); IR-2013-86.
6. See IRC Sec. 414(v).

compensation over any other elective deferrals for the year made without regard to the catch-up limits.[1] The dollar limit is $2,500 in 2010-2014.[2] See Appendix E for earlier years.

A SIMPLE IRA will not be treated as violating any of the applicable limitations of Section 408(p) merely on account of the making of (or right to make) catch-up contributions, provided a universal availability requirement is met.[3] See Q 3706 for details on the requirements for catch-up contributions.

Elective contribution amounts made under the salary reduction portion (i.e., those subject to the $12,000 limit) of a SIMPLE IRA plan are counted in the overall limit ($17,500 in 2013 and 2014) on elective deferrals by any individual.[4] See Q 3705 for the definition of "elective deferral." Thus, for example, an individual under age 50 who defers the maximum of $12,000 to a SIMPLE IRA of one employer and participates in a 401(k) plan of another employer would be limited to an elective deferral of $5,500 in 2014 ($17,500 - $12,000) to the 401(k) plan. Catch-up contributions are not subject to the limits of IRC Section 402(g) and do not reduce an individual's otherwise applicable deferral limit under any other plan.[5]

Definitions

An arrangement will not be treated as a *qualified salary reduction arrangement* if the employer, or a predecessor employer, maintained another qualified plan (including a 403(a) annuity, a 403(b) tax sheltered annuity, a SEP, or a governmental plan other than an IRC Section 457 plan) under which contributions were made or benefits accrued for service during any year in which the SIMPLE IRA plan was in effect. But if only employees *other than* those covered under a collectively bargained agreement are eligible to participate in the SIMPLE IRA plan, this rule will be applied without regard to a collectively bargained plan.[6] Also, for purposes of this rule, transfers, rollovers, or forfeitures are disregarded except to the extent that forfeitures replace otherwise required contributions.[7]

Only an *eligible employer* may adopt a SIMPLE IRA plan. An "eligible employer" is defined as an employer who employed no more than 100 employees earning at least $5,000 from the employer during the preceding year.[8] For purposes of this limitation, *all* employees employed at any time during the calendar year are taken into account, even those who are excludable or are ineligible to participate. Furthermore, certain self-employed individuals who receive earned income from the employer during the year must be counted for purposes of the 100-employee limitation.[9] An employer who maintains a plan in which only collectively bargained employees may participate is not precluded from offering a SIMPLE IRA to its noncollectively bargained employees.[10]

1. IRC Sec. 414(v)(2)(A).
2. IRC Sec. 414(v)(2)(B)(ii); IR-2009-94.
3. IRC Sec. 414(v)(3); see Prop. Treas. Reg. §1.414(v)-1(d).
4. IRC Sec. 402(g)(3)(D); IR-2013-86.
5. IRC Sec. 414(v)(3)(A).
6. IRC Sec. 408(p)(2)(D).
7. Notice 98-4, 1998-1 CB 269.
8. IRC Sec. 408(p)(2)(C)(i).
9. Notice 98-4, 1998-1 CB 269.
10. IRC Sec. 408(p)(2)(D)(i).

Generally, an eligible employer who ceases to be eligible after having established and maintained a SIMPLE IRA plan for at least one year will, nonetheless, continue to be treated as eligible for the following two years.[1] But special rules apply where a failure to remain eligible (or to meet any other requirement of IRC Section 408(p)) was due to an acquisition, disposition, or similar transaction involving another eligible employer.[2]

Compensation, for purposes of most of the SIMPLE IRA provisions, includes wages (as defined for income tax withholding purposes), elective contributions made under a SIMPLE IRA plan, and elective deferrals, including compensation deferred under an IRC Section 457 plan.[3] A self-employed individual who is treated as an employee may be a participant in a SIMPLE IRA plan; for this purpose, "compensation" means net earnings from self-employment, prior to subtracting the SIMPLE IRA plan contribution.[4] An employee's elective deferrals under a 401(k) plan, a SAR-SEP, and a Section 403(b) annuity contract are also included in the meaning of compensation for purposes of the 100-employee limitation (i.e., the $5,000 threshold) and the eligibility requirements.[5]

3655. What requirements apply to employer contributions to a SIMPLE IRA plan?

The requirements for the employer's contributions to employee SIMPLE plans are as follows:

Matching formula: Under this formula, the employer is generally required to match employee contributions dollar-for-dollar up to 3 percent of the employee's compensation.[6] (Matching of catch-up contributions is not required.[7])The employer may elect to reduce the matching percentage in a calendar year for all eligible employees, but such reduced percentage cannot be below 1 percent. To get the lower percentage, the employer has to notify the employees of the election within a reasonable period of time before the 60-day election period for electing to participate in the plan. Also, the employer may not use the lower percentage if the election would result in the percentage being lower than 3 percent in more than two out of the five years ending with the current year. If the employer (or a predecessor employer) has maintained the plan for less than five years, the employer will be treated as if the percentage was 3 percent in the prior years during which the arrangement was not in effect.[8] Also, if the employer made nonelective contributions for a year (instead of matching contributions) under the formula described below, it will be treated as having a percentage of 3 percent in that year.[9]

The compensation limit under IRC Section 401(a)(17) does not apply for purposes of the matching formula; thus, the 3 percent match could reach the maximum of $12,000 (in 2014) for an employee with compensation of $400,000 in a year.[10]

1. IRC Sec. 408(p)(2)(C)(i)(II).
2. See IRC Sec. 408(p)(10).
3. IRC Sec. 408(p)(6)(A).
4. IRC Sec. 408(p)(6)(A)(ii).
5. Notice 98-4, 1998-1 CB 269.
6. IRC Sec. 408(p)(2)(A)(iii).
7. See REG-142499-01, 66 Fed. Reg. 53555 (Oct. 23, 2001).
8. IRC Sec. 408(p)(2)(C)(ii).
9. Notice 98-4, 1998-1 CB 269.
10. See Notice 98-4, 1998-1 CB 269; IRC Sec. 401(a)(17).

A matching contribution made to a SIMPLE IRA on behalf of a self-employed individual is not treated as an elective employer contribution for purposes of the limit on such contributions.[1] The purpose of this provision is to treat self-employed individuals in the same manner as employees for purposes of the limit on elective contributions.

Nonelective contribution formula: As an alternative to making a matching contribution, an employer can elect to make a nonelective contribution of 2 percent of compensation on behalf of each eligible employee with at least $5,000 in compensation from the employer for the year. The employer is required to make a nonelective contribution for all eligible employees regardless of whether the employee has made a contribution to the Simple IRA for the calendar year.

If the employer makes this election, it must notify the employees within a reasonable time before the 60-day election period for electing to participate in the plan.[2] The compensation limit under IRC Section 401(a)(17) does apply for purposes of this formula; thus, the maximum amount that could be contributed in nonelective contributions for an employee would be $5,200 (i.e., 2 percent of $260,000 (in 2014)).[3]

A SIMPLE IRA is not subject to the nondiscrimination or top-heavy rules, and the reporting requirements it must meet are simplified.[4]

3656. Do any special rules apply to a SIMPLE IRA plan?

Contributions under a SIMPLE IRA plan may be made only to a SIMPLE IRA, and a SIMPLE IRA may receive only contributions under a SIMPLE IRA plan and rollovers or transfers from another SIMPLE IRA account.[5] All contributions to a SIMPLE IRA account must be fully vested and may not be subject to any prohibition on withdrawals, nor conditioned on their retention in the account.[6] The early distribution penalty on withdrawals, however, is increased to 25 percent during the first two years of participation (Q 3657).[7]

The *participation* requirements for SIMPLE IRAs state that all nonexcludable employees who received at least $5,000 in compensation from the employer during any two preceding years and are reasonably expected to receive at least $5,000 in compensation during the year must be eligible to make the cash or deferred election (if the matching formula is used) or to receive nonelective contributions (if the nonelective formula is used).[8] Of course, employers are free to impose less restrictive eligibility requirements, such as a $3,000 compensation threshold, but they may not impose more restrictive ones.[9] The $5,000 threshold compensation amount is not scheduled to be indexed for inflation. Nonresident aliens who received no U.S.

1. IRC Sec. 408(p)(9).
2. IRC Sec. 408(p)(2)(B).
3. See IRC Sec. 408(p)(2)(B)(ii).
4. See IRC Secs. 408(p)(1), 416(g)(4), 408(l)(2).
5. Notice 98-4, 1998-1 CB 269, A-2.
6. IRC Secs. 408(p)(3), 408(k)(4).
7. IRC Sec. 72(t)(6).
8. IRC Sec. 408(p)(4)(A).
9. Notice 98-4, 1998-1 CB 269.

income and employees subject to a collective bargaining agreement generally are excludable employees for purposes of the participation requirement.[1] An employee who participates in another plan of a different employer may participate in a SIMPLE IRA plan, but will be subject to the aggregate limit of $17,500 (in 2014) on elective deferrals. An employer who establishes a SIMPLE IRA plan is not responsible for monitoring compliance with this limitation.[2]

Tax-exempt employers and governmental entities are permitted to maintain SIMPLE IRA plans. Excludable contributions may be made to the SIMPLE IRA of employees of tax-exempt employers and governmental entities on the same basis as contributions may be made to employees of other eligible employers.[3] Related employers (i.e., controlled groups, partnerships or sole proprietorships under common control, and affiliated service groups) must be treated as a single employer for purposes of the SIMPLE IRA rules, and leased employees will be treated as employed by the employer. Consequently, all employees (and leased employees) of an employer who satisfy the eligibility requirements (see below) must be permitted to participate in the SIMPLE IRA of a related employer.[4]

The administrative requirements for SIMPLE IRA plans state that an employer must make elective employer contributions (elective deferrals) within 30 days after the last day of the month with respect to which the contributions are to be made, and that matching and nonelective contributions must be made no later than the filing date for the return for the taxable year (including extensions).[5]

Planning Point: While the IRS requires elective employer contributions within 30 days after the month with respect to which the contributions are made, the Department of Labor requires that employee deferrals be made *as soon as practicable* after the deferral, but in no event later than 15 days after the deferral was made. *Ward Anderson, CLU, ChFC, MassMutual Financial Group, Denver, Colorado*.

Employees must have the right to terminate participation at any time during the year; but the plan may preclude the employee from resuming participation thereafter until the beginning of the next year.[6]

Generally, each employee must have 60 days before the first day of any year (and 60 days before the first day the employee is eligible to participate) to elect whether to participate in the plan, or to modify his deferral amount.[7] A SIMPLE IRA plan must be maintained on a calendar year basis.[8] The IRS apparently has adopted a requirement that a plan be adopted not later than October 1 of the year for which the plan is established, but states that the October 1 requirement "does not apply to a new employer that comes into existence after October 1 of the year the SIMPLE IRA Plan is established if the employer establishes the SIMPLE IRA Plan as soon

1. IRC Sec. 408(p)(4)(B).
2. Notice 98-4, 1998-1 CB 269.
3. Notice 98-4, 1998-1 CB 269.
4. Notice 98-4, 1998-1 CB 269.
5. IRC Secs. 408(p)(5)(A), 404(m)(2)(B).
6. IRC Sec. 408(p)(5)(B).
7. IRC Sec. 408(p)(5)(C).
8. See Notice 98-4, 1998-1 CB 269.

as administratively feasible after the employer comes into existence."[1] See Q 3657 regarding the tax treatment of SIMPLE IRA plan contributions, distributions, and rollovers. See Q 3715 regarding SIMPLE 401(k) plans.

3657. How are SIMPLE IRA plan contributions taxed?

There are four possible types of contributions to a SIMPLE IRA plan.

(1) Salary reduction contributions

(2) Catch-up contributions

(3) Matching contributions

(4) Nonelective contributions[2]

Salary reduction and catch-up contributions are made by the employee, and the employer is responsible for making either a matching or nonelective contribution.

Catch-up contributions are additional elective deferrals (not subject to the $12,000 ceiling in 2014) for individuals age fifty or over (Q 3654, Q 3706). All SIMPLE IRA contributions are excludable from the employee's income, provided they meet certain design requirements set forth in the IRC.[3] Moreover, certain lower income taxpayers may be eligible to claim the saver's credit for salary reduction contributions to a SIMPLE IRA (Q 3607).

Contributions to a SIMPLE IRA are not subject to income tax withholding, but salary reduction contributions are included in wages for purposes of Social Security tax and federal unemployment tax (i.e., FICA and FUTA). Consequently, salary deferrals are subject to FICA and FUTA withholding. It appears that "salary deferrals," for this purpose, would include catch-up contributions.[4] By contrast, matching contributions and nonelective contributions made by the employer are excluded from wages for purposes of Social Security tax and federal unemployment tax; they are not subject to FICA or FUTA withholding.[5]

Employer contributions to a SIMPLE IRA generally are deductible by the employer.[6] Matching and nonelective contributions can be made after the close of the tax year to which they are attributable, provided they are made before the due date for filing the employer's federal income tax return for the taxable year (including extensions).[7] Contributions to a SIMPLE IRA are not subject to the annual dollar limit for traditional or Roth IRAs.[8] Nondeductible contributions are subject to a 10 percent penalty.[9]

1. See Notice 98-4, 1998-1 CB 269, at K-1.
2. See IRC Secs. 408(p)(2), 414(v).
3. See IRC Secs. 402(k), 402(h)(1), 402(e)(3); see IRC Sec. 414(v); Notice 98-4, 1998-1 CB 25.
4. See IRC Secs. 414(v)(1), 414(v)(6)(B).
5. See IRC Secs. 3121(a), 3306(a), 3401(a)(12); Notice 98-4, 1998-1 CB 25.
6. IRC Sec. 404(m)(1).
7. IRC Sec. 404(m)(2)(B).
8. IRC Sec. 408(p)(8).
9. IRC Sec. 4972(d)(1)(A)(iv).

SIMPLE IRA accounts themselves are not subject to tax. The taxation of distributions from a SIMPLE IRA is the same as under a traditional IRA; thus, contributions generally are not taxable until withdrawn.[1] The early distribution penalty (Q 3629) is increased to 25 percent during the first two years of participation in a SIMPLE IRA; after the two year period has elapsed, the penalty is 10 percent.[2]

A SIMPLE IRA may not be designated as a Roth IRA.[3]

3658. Are rollovers permitted from SIMPLE IRA plans?

Tax-free rollovers (Q 3891) may be made from one SIMPLE IRA to another SIMPLE IRA at any time, but a rollover from a SIMPLE IRA to a traditional IRA is permitted only in the case of distributions to which the 25 percent early distribution penalty does not apply (Q 3657).[4] During the two year period that the 25 percent penalty is imposed, such a transfer would be treated as a distribution from the SIMPLE IRA and a contribution to the other IRA that does not qualify as a rollover contribution.[5] To the extent that an employee is no longer participating in a SIMPLE IRA plan and two years have expired since the employee first participated in the plan, the employee may treat the SIMPLE IRA account as a traditional IRA.[6]

3659. Is the value of a survivor benefit payable under an IRA includable in the decedent's gross estate?

Yes, generally, in the case of decedents dying after 1984. For details, see below. Benefits payable to a surviving spouse generally will qualify for the marital deduction (Q 3660).

The value of an IRA account is not discounted for income tax payable by beneficiaries or for lack of marketability. An income tax deduction may be available for federal estate tax attributable to the IRA.[7]

The value of an annuity or other payment receivable under an individual retirement plan or arrangement by the beneficiary of a deceased individual is includable in the decedent's gross estate under the rules discussed in Q 542 to Q 550. In reading those rules, be aware that any contribution for the purchase of an annuity made by the decedent's employer or former employer, as under an SEP (Q 3650), is considered to be contributed by the decedent if made by reason of his or her employment.[8]

For estates of decedents dying after 1984, the Tax Reform Act of 1984 generally repealed the previously existing estate tax exclusion; special rules may apply for decedents dying after 1984 who separated from service before January 1, 1985. Qualified plan benefits rolled over

1. IRC Secs. 402(k), 402(h)(3); General Explanation of Tax Legislation Enacted in the 104th Congress (JCT-12-96), p. 141 (the 1996 Blue Book).
2. IRC Sec. 72(t)(6).
3. IRC Sec. 408A(f)(1).
4. IRC Sec. 408(d)(3)(G).
5. Notice 98-4, 1998-1 CB 25.
6. General Explanation of Tax Legislation Enacted in the 104th Congress (JCT-12-96), p. 141 (the 1996 Blue Book).
7. *Est. of Smith v. U.S.*, 198 F. 3d 515 (5th Cir. 1999), nonacq.; *Est. of Kahn v. Comm.*, 125 TC 227 (2005); TAM 200247001.
8. IRC Sec. 2039(b).

to an IRA after 1984 are treated as subject to the transitional rules for IRAs rather than those for qualified plans (Q 3877).[1]

3660. Is a marital deduction available for the value of a survivor benefit payable under an individual retirement plan that is includable in the decedent's gross estate?

Yes, if benefits pass to the surviving spouse in a form that qualifies for the marital deduction.[2] Thus, an outright transfer of the IRA account balance to the surviving spouse should qualify for the marital deduction. A marital deduction also should be available if any income or principal distributed while the surviving spouse is alive is distributed to the surviving spouse and principal and income, if any, is distributed to the surviving spouse's estate at death.

A marital deduction also should be available if all income from the IRA is distributed at least annually to the surviving spouse and the surviving spouse is given a general power to appoint the IRA to himself or herself or to his or her estate.[3] Additionally, a marital deduction should be available if all income from the IRA is distributed at least annually to the surviving spouse, no one has the power to distribute any part of the IRA to anyone other than the surviving spouse, and the executor makes a qualified terminable interest property ("QTIP") election.[4] If the surviving spouse is given a survivor annuity where only the spouse has the right to receive payments during such spouse's lifetime, such interest would qualify for the QTIP marital deduction.[5] In the case of a surviving spouse who is not a U.S. citizen, a qualified domestic trust generally would be required to obtain the marital deduction.[6]

Planning Point: All of the QTIP trust income must be received by the surviving spouse for life. Such income is sometimes defined by state law as unitrust interest.

An executor can elect to treat an IRA and a trust as QTIP if the trustee of the trust is the beneficiary of the IRA, the surviving spouse can compel the trustee to withdraw all income earned by the IRA at least annually and distribute that amount to the spouse, and no person has the power to appoint any part of the trust to any person other than the spouse.[7]

Prior to Revenue Ruling 2000-2, where IRA proceeds were to be distributed to a trust benefiting the survivor spouse, marital deduction requirements generally had to be met at both the IRA and the trust level.

Thus, in Revenue Ruling 89-89,[8] a decedent's executor was permitted to elect to treat a decedent's IRA as eligible for the QTIP marital deduction where (1) the distribution option elected by the decedent for the IRA required the principal balance of the IRA to be distributed

1. Rev. Rul. 92-22, 1992-1 CB 313; *Sherrill v. U.S.*, 415 F. Supp. 2d 953 (N.D. Ind. 2006).
2. IRC Sec. 2056.
3. IRC Sec. 2056(b)(5).
4. IRC Sec. 2056(b)(7).
5. IRC Sec. 2056(b)(7)(C).
6. IRC Secs. 2056(d), 2056A; Let. Ruls. 9544038, 9322005.
7. Rev. Rul. 2000-2, 2000-1 CB 305, superseded by Rev. Rul. 2006-26; 2006-1 C.B. 939
8. 1989-2 CB 231, superseded by Revenue Ruling 2000-2.

in annual installments to a testamentary QTIP trust and the income earned on the undistributed balance of the IRA to be distributed annually to the trust, and (2) all trust income was payable annually to the decedent's spouse.

A QTIP marital deduction was not available for an IRA with distributions payable to a marital trust where none of the IRA options provided that all income would be distributed at least annually to the marital trust.[1]

In determining if a spouse has been given an income interest, allocations between income and principal will be respected if state law provides that reasonable apportionments can be made between income and remainder beneficiaries of the total return of the trust (e.g., a unitrust interest in the range of 3 percent to 5 percent could be treated as an income interest).[2] Revenue Ruling 2006-26[3] provides that various means of determining income under state law are permitted under the QTIP marital deduction. Thus, income generally can be determined under state laws based on the Uniform Principal and Income Act or under general traditional statutory or common law rules that provide for allocations between income and principal.

A marital deduction also may be available if IRA proceeds are paid to a charitable remainder annuity trust or unitrust and the surviving spouse is the only noncharitable beneficiary (other than certain ESOP remainder beneficiaries).[4] Presumably, the IRA would have to incorporate all the charitable deduction requirements for such a trust.

For the income tax implications of distributions from a traditional IRA, see Q 3625, from a Roth IRA, see Q 3626.

3661. What is a "myRA"?

The "myRA" is a type of retirement savings account introduced by the government in 2014 that is designed to expand and simplify the use of retirement savings accounts for taxpayers who do not otherwise have access to employer-sponsored retirement savings plans. Essentially, the myRA is designed to be treated as a Roth IRA, except that amounts contributed to a myRA will be invested in Treasury securities, and will earn the same interest rate as the Government Securities Investment Fund in the Thrift Savings Plan for federal employees.

There are no fees associated with a myRA account, which will be portable between employers.[5]

The Treasury Department has indicated that it will begin implementing the myRA program late in 2014, and will issue additional guidance in the future.

See Q 3662 for eligibility requirements, Q 3663 for contribution rules and Q 3664 for distribution requirements.

1. TAM 9220007.
2. Treas. Reg. §1.643(b)-1.
3. 2006-1 CB 939.
4. IRC Sec. 2056(b)(8).
5. See http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf for Treasury Department guidance (last accessed July 25, 2014).

3662. Who is eligible to open a myRA?

Initial guidance released by the Treasury Department with respect to the myRA program indicates that the myRA will be available to taxpayers with annual income that is below the inflation-adjusted limitations for contributing to Roth IRAs. This means that individual filers with annual income of less than $129,000 and joint filers with annual income of less than $191,000 (as adjusted for inflation) are eligible to contribute.[1] According to the Treasury Department guidance, it is the individual taxpayer, not the employer, who is responsible for ensuring compliance with these limitations.[2]

While all taxpayers who meet the income limitations are eligible to participate, there is no requirement that all employers offer myRA plans.

3663. How are contributions to a myRA made?

Employees of participating employees will sign up for myRA accounts online and will make contributions through payroll direct deposit that is arranged through the employer. The initial minimum contribution will be $25. Following the initial contribution, the employee can elect to contribute $5 or more from each paycheck. These contributions will be made automatically via direct deposit into the myRA. Matching employer contributions will not be permitted.[3]

3664. Are there any distribution requirements that will apply with respect to a myRA?

While not specifically termed a distribution requirement, preliminary guidance has provided that the value of any given myRA account will be capped at $15,000. Once the account value reaches $15,000 (or after 30 years have passed, whichever occurs first), the myRA funds will be rolled over into a private-sector IRA.[4] As of the date of this publication, the rules governing myRA-to-IRA rollovers have not been released.

As with a traditional Roth vehicle, contributions can be withdrawn tax-free. Earnings on the taxpayer's contributions can be withdrawn tax-free once five years have passed if the taxpayer has attained age 59½.[5]

1. See http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf for Treasury Department guidance (last accessed July 25, 2014).
2. See Treasury Department myRA Top Questions and Answers, available at http://www.myra.treasury.gov/readysavegrow/myra/myra_top_questions.htm (last accessed July 25, 2014).
3. See http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf for Treasury Department guidance (last accessed July 25, 2014).
4. See http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf for Treasury Department guidance (last accessed July 25, 2014).
5. See Treasury Department myRA Top Questions and Answers, available at http://www.myra.treasury.gov/readysavegrow/myra/myra_top_questions.htm (last accessed July 25, 2014).