INDIVIDUAL RETIREMENT ACCOUNTS

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Individual Retirement Accounts

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# About This Course

## Learning Objectives

Upon completion of this basic course, the student should be able to:

1. Discuss the rules governing eligibility and permitted contribution levels for traditional and Roth IRAs.
2. Explain the tax treatment of contributions to and distributions from traditional and Roth IRAs.
3. Describe the benefits of tax-deferred accumulation.
4. Explain the rules concerning permitted IRA investments.
5. Discuss traditional and Roth IRA distribution rules.
6. Explain Coverdell Education Savings Account contribution and distribution rules and their tax implications.
7. Discuss the contribution and distribution rules that apply to SEP IRAs and SIMPLE IRAs.

No prerequisite or advance preparation is necessary.

## How You Will Learn

In this course you will be introduced to terms and concepts used in connection with individual retirement accounts. Each new term is defined in the text and included in the Glossary. The concepts are explained and, where appropriate, are demonstrated through the use of examples.

At the conclusion of each important section, a Review Quiz is presented to test comprehension of the material presented. A response is given to each answer you select to the questions in the Review Quiz affirming the correct choice or explaining why the choice you selected was incorrect.

## Why This Information is Important and How You Can Use It

This information is important for advisers who are counseling clients on the eligibility, taxation and other rules applicable to individual retirement accounts. Accordingly, the course provides information concerning the tax treatment of contributions, accumulations, transfers and distributions as well as the premature distribution penalties and required minimum distribution penalties that may apply.

By fully understanding the rules applicable to various types of individual retirement accounts, advisers will be better able to meet their clients’ needs.

# Chapter 1 Traditional Individual Retirement Accounts

## Important Lesson Points

The important points addressed in this lesson are:

* Individual retirement accounts, initially authorized by Congress to enable individuals to make tax-deductible contributions to their personal retirement plan, have expanded to provide spousal benefits, education benefits, and—in certain cases—tax-free retirement benefits
* Except for spousal IRAs, the only eligibility requirements to establish a traditional IRA are earned income and (except in the case of Roth IRAs) not having reached age 70½
* The maximum annual IRA contribution applies to the aggregate contribution to both traditional and Roth IRAs and have been increased by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)
* EGTRRA has made provision for catch-up IRA contributions for individuals age 50 and over and for nonrefundable tax credits for certain lower-income contributors
* Although there is broad eligibility to make a traditional IRA contribution, deductibility of a traditional IRA contribution may be reduced or eliminated for active participants in an employer-sponsored retirement plan, depending on their adjusted gross income
* Traditional individual retirement accounts enjoy income tax advantages—contribution deductibility and income tax deferral of gain—that can dramatically increase accumulations
* The generally greater traditional IRA accumulations due to tax-deductibility and tax-deferral result from the ability of earnings that might have otherwise been used to pay taxes to remain in the account and earn additional income
* The longer that traditional IRA contributions remain in an account the greater the positive effects on accumulations of tax-deductibility and tax-deferral
* Funds in a traditional IRA may be rolled over to another traditional IRA or to a qualified plan, a §403(b) tax-sheltered annuity or a §457 governmental plan
* Funds that are rolled over according to the rules prescribed in the Internal Revenue Code avoid current inclusion in income and continue to enjoy tax deferral
* Distributions from qualified plans are subject to 20% income tax withholding even if the distributed funds are subsequently rolled over. Participants may avoid the tax withholding on qualified plan rollovers by arranging for a direct rollover on a trustee-to-trustee basis..
* Rollovers of distributions from IRAs, qualified plans, §403(b) tax-sheltered annuities or a §457 governmental plans must be completed within 60 days of distribution in order to retain their tax advantages
* The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) liberalized the rules governing rollovers by permitting rollovers of certain after-tax contributions and enabling the Secretary of the Treasury to waive the 60-day rule when the facts support the waiver
* Traditional individual retirement account distributions, other than distributions of after-tax contributions, are fully taxable as ordinary income in the year in which received
* Normal traditional IRA distributions may begin without a premature distribution tax penalty when the owner attains age 59½
* Premature distributions from traditional IRAs, in addition to the ordinary income tax payable, are subject to a tax penalty equal to 10 percent of the taxable distribution
* Certain exceptions apply by virtue of which the premature disbursement tax penalty is waived
* Non-deductible contributions are received tax-free from traditional IRA distributions
* Required minimum distributions (RMDs) from traditional IRAs must begin by the owner’s age 70½
* Traditional IRA owners age 70 ½ and older who fail to take distributions at least equal to the RMD amount are subject to a 50% penalty tax on the insufficiency.

## Chapter Learning Objectives

In this chapter we will look at the initial IRA rules and the principal changes to the program since its inception. When you have completed this chapter you should be able to:

* Describe the general provisions and limits applicable to IRAs at the time of their introduction;
* Identify the enhancements made to the early IRA program that currently permit:
  + Spousal IRAs for unemployed spouses,
  + Active participants in employer-sponsored qualified plans to participate in IRAs,
  + Eligible individuals to participate in Roth IRAs that offer tax-free qualified distributions, and
  + Contributions to be made to Coverdell Education Savings Accounts.

## Background, Definition & Eligibility

ERISA, the Employee Retirement Income Security Act, created an individual retirement account—usually referred to simply as an IRA—to allow people who had no other employer-sponsored qualified plan to have certain tax support for a retirement program. That was the initial legislative intent. In order to participate, you needed to be employed and not be a participant in a pension, profit-sharing or other qualified plan.

These early ERISA individual retirement account provisions have been extended to provide for:

* Unemployed spouses
* Qualified plan participants
* Non-deductible contributions to Roth IRAs
* Education IRAs, now called Coverdell Education Savings Accounts

Early expansion of the IRA provisions added a spousal IRA that is designed to provide retirement assistance to uncompensated homemakers. It was also expanded to allow employees who were covered under a pension or profit-sharing plan to contribute to an IRA. In fact, when initially amended, ERISA also provided qualified plan participants with an unlimited tax deduction for their IRA contributions.

Since that earlier ERISA expansion related to IRAs, new IRAs have been added. These newer IRAs are Roth IRAs and Education IRAs, subsequently re-named Coverdell Education Savings Accounts. In order to differentiate the newer Roth IRA from its earlier cousin, the original IRA is now referred to as a “traditional” IRA.

Let’s begin our IRA discussion with an examination of the traditional IRA rules.

## Traditional IRA Rules

A traditional IRA is a personal retirement savings plan, funded by an annuity or a trust that meets certain requirements and which may permit tax-deductible contributions and tax-deferral of earnings. To be eligible to contribute to a traditional non-spousal IRA, an individual must meet two conditions:

* Have earned income, and
* Not yet have attained age 70 1/2.

We will see, shortly, that the earned income requirement does not apply to spousal IRAs.

A distinction needs to be made between an individual’s eligibility to contribute to a traditional IRA and his or her eligibility to take a tax deduction for that contribution. We will see that the individual’s ability to contribute to a traditional IRA is much broader than the ability to tax-deduct the contribution. In other words, an individual may be eligible to make a traditional IRA contribution but, in certain cases, may not be permitted to take a deduction for that IRA contribution.

The requirement that the individual making a contribution to a traditional IRA not have attained age 70½ is important because 70½ is the age at which required minimum distributions from many tax-favored plans must generally begin. Specifically, the federal government requires that individuals who have accumulated funds in tax-qualified plans on which no income tax has been paid must begin to receive those funds at some point and pay income taxes as they are received. For traditional IRAs, that point is reached when the individual attains age 70½.

### Earned Income

We noted that one of the criteria for the eligibility to contribute to a traditional IRA is that the individual have earned income. The IRA legislation defines earned income as:

* Salary
* Fees
* Tips
* Bonus
* Commission
* Alimony

There is a requirement, except in the case of alimony, that the amounts received be derived from personal services that are actually rendered. What the IRA rules don’t include under the heading of earned income is interest, dividends or capital gains. They are considered unearned income and do not qualify as the basis for an IRA contribution.

The only traditional IRA that doesn’t require that the participant have an earned income is a spousal IRA. Obviously, since spousal IRAs were created specifically to permit contributions for an un-compensated spouse, it would not make any sense to require that the spouse have earned income!

Although the participant in a spousal IRA is not required to meet the earned income requirement for contribution to an IRA, a spousal IRA is available only if the participant is married and filing federal income tax on a joint basis. Furthermore, a spousal IRA, if established, must be a separate account and not commingled with the working spouse’s IRA. It is not dependent upon nor can it be added to the working spouse’s IRA. A separate IRA account or annuity must be established to hold the spousal IRA contribution.

## Limits on Contributions

The Taxpayer Relief Act of 1997 authorized Roth IRAs. Before the creation of Roth IRAs, IRA contributions were limited to the lesser of $2,000 and 100% of the individual’s earned income. Since Roth IRAs have come upon the scene, the contribution limits have also changed.

The contribution limits to a traditional IRA are reduced by any contribution for the same tax year to a Roth IRA. So, the annual contribution limits to an IRA apply to both traditional IRA contributions and Roth IRA contributions. To the extent that an individual makes a contribution to one, it limits the amount of contribution he or she may make to the other for the same tax year.

If an individual failed to realize that his or her contribution to a traditional IRA needed to be reduced by the amount contributed to the Roth IRA and, as a result, over-contributed an excise tax penalty of 6% is levied annually until the excess is withdrawn. The penalty tax is non-deductible and applies even though the excess contribution was made inadvertently.

The penalty tax will not apply if the excess contribution is removed, along with any net income attributable to the excess contribution, from the IRA account at any time before the tax return is due for the year for which the contribution was made. Any extensions on filing a tax return also extend this deadline. Interestingly, however, even though the excise tax penalty would be avoided by timely removal of the excess contribution, the accompanying net income that must also be removed is includible in the individual’s income and subject to premature withdrawal penalties.

Excess contributions to an IRA cannot be applied as contributions for the following year. These excess funds must be withdrawn to avoid the 6 percent penalty.

### Maximum Annual Contributions

The maximum permitted contribution to an IRA—an amount that had remained level at $2,000 for many years—has been increased by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) with respect to:

* Regular contributions
* Catch-up contributions

The maximum annual contribution amount to an IRA depends on the tax year for which the contribution is made, as shown in the table below:

|  |  |
| --- | --- |
| **Tax Year** | **Maximum Contribution** |
| 2005 – 2007 | $4,000 |
| 2008 – 2012 | $5,000 |
| 2013 | $5,500 |
| 2014 | $5,500 |
| 2015 | $5,500\* |
| \*Indexed for inflation in $500 increments | |

In addition to these increases in regular IRA contribution limits, EGTRRA permits catch-up IRA contributions for individuals who have attained age 50 before the close of the taxable year for which the IRA contribution is made. The amount of these additional contributions also depends on the tax year for which the catch-up contribution is made. The maximum catch-up contributions are shown below:

|  |  |
| --- | --- |
| Tax Year | Maximum Catch-Up Contribution |
| 2002 – 2005 | $500 |
| 2006 and later | $1,000 |

Note that even though EGTRRA authorizes larger IRA contributions, the basic requirement continues that the contribution may not exceed the increased dollar limit or 100 percent of compensation.

## Traditional IRA Tax Considerations

The legislation creating IRAs and its subsequent expansion is intended to place the federal government in the role of a facilitator—enabling individuals to provide their own retirement income—rather than as a primary provider of retirement security. The means by which government often encourages actions that it deems desirable is through tax advantages and incentives. IRAs are no exception to that principle. Tax treatment plays a substantial role in the popularity of IRAs.

In considering the tax treatment of traditional IRAs, we need to examine IRAs from four perspectives:

* Contributions
* Accumulations
* Transfers, and
* Distributions

### Traditional IRA Tax Considerations—Contributions

We need to make an initial distinction in our discussion of the tax treatment of contributions to a traditional IRA. That distinction relates to whether or not the individual making the contribution is an active participant in an employer-sponsored retirement plan.

An employer-sponsored retirement plan includes a:

* Pension plan
* Profit sharing plan
* 401(k) plan
* 403(b) tax sheltered annuity plan
* Simplified employee pension (SEP)
* SIMPLE IRA

If the individual is an active participant, the deduction for his or her contribution may be reduced or eliminated.

Any qualified retirement plan sponsored by an employer qualifies as an employer-sponsored retirement plan. In certain cases, a qualified retirement plan is considered an employer-sponsored retirement plan even if the employer makes no contributions to it. Examples of these plans are unmatched 401(k) and 403(b) plans.

If the individual is not an active participant in an employer-sponsored retirement plan and is otherwise eligible to contribute to a traditional IRA, his or her contribution is fully tax-deductible up to the maximum permitted contribution—regardless of the individual’s income level. Although an active participant is eligible to make a contribution, his or her contribution may or may not be deductible or may only be partially deductible.

#### Tax Treatment of Contributions by Active Participants

There are three possibilities with respect to the tax deductibility of a traditional IRA contribution made by an active participant. The traditional IRA contribution may be:

* Fully deductible, or
* Partially deductible, or
* Not deductible

The tax status of a traditional IRA contribution for an active participant depends entirely on his or her adjusted gross income and income tax filing status.

The reduction of the deductible amount of a traditional IRA contribution for an active participant filing a *single or head-of-household* federal tax return is determined by using the following formula:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction of Deduction | = | Maximum contribution | x | AGI – applicable dollar amount $10,000 |

The reduction of the deductible amount of a traditional IRA contribution for an active participant filing a *joint* federal tax return is determined by using the following formula:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction of Deduction | = | Maximum contribution | x | AGI – applicable dollar amount $20,000 |

(Note: The difference between the two formulas shown above is in the denominator of the fraction. For active participants filing single or head-of-household federal tax returns, the denominator is $10,000; for active participants filing a joint federal tax return, it is $20,000.)

The “applicable dollar amount” that must be used in the above formula depends on:

* The tax year, and
* The individual’s tax filing status

If the individual is an active participant in an employer-sponsored retirement plan and files his or her federal income tax return as single or head-of-household, the applicable dollar amount for 2015 is $61,000. Let’s apply the formula to a hypothetical, but real-life, situation to see how it works.

Suppose that a 40 year-old client, John Burns, is a single man who has an adjusted gross income of $64,000 in 2015. Since he is an active participant in his employer’s pension plan, he wants to determine how much of the maximum IRA deductible amount he qualifies for. By substituting the appropriate numbers in the formula, we can see that his maximum deductible amount is $3,850. The formula is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction of Deduction | = | Maximum contribution | x | AGI – applicable dollar amount  $10,000 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $1,650 | = | $5,500 | x | $64,000 – 61,000  $10,000 |

Since the maximum permitted deduction for 2015 is $5,500, and the reduction determined by the formula is $1,650, John’s permitted deduction is simply the difference—$3,850. ($5,500 - $1,650 = $3,850) Although John’s *deduction* is limited to $3,850, he may contribute the entire $5,500 to a traditional IRA; the additional $1,650, however, is not deductible.

|  |
| --- |
| **Single or Head of Household Active Participants** |

|  |  |
| --- | --- |
| Taxable Years | Applicable Dollar Amount |
| 2011 | $56,000 |
| 2012 | $58,000 |
| 2013 | $59,000 |
| 2014 | $60,000 |
| 2015 | $61,000 |

If the individual is an active participant in an employer-sponsored retirement plan and files a joint federal income tax return, the applicable dollar amount is higher, as shown below:

|  |
| --- |
| **Joint Return Active Participants** |

|  |  |
| --- | --- |
| Taxable Years | Applicable Dollar Amount |
| 2011 | $90,000 |
| 2012 | $92,000 |
| 2013 | $95,000 |
| 2014 | $96,000 |
| 2015 | $98,000 |

Suppose that John’s 45 year-old married brother, Tom Burns, is also an active participant in his employer’s pension plan and has an adjusted gross income in 2015 of $103,000. He too wants to determine how much of the maximum IRA deductible amount he qualifies for. We can make the same substitutions into the formula and find that his maximum deductible amount is $4,125. The formula for an active participant filing a *joint federal tax return* is used in this case:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction of Deduction | = | Maximum contribution | X | AGI – applicable dollar amount  $20,000 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $1,375 | = | $5,500 | x | $103,000 – 98,000  $20,000 |

Since the maximum permitted deduction for 2015 is $5,500, and the reduction determined by the formula is $1,375, Tom’s permitted deduction is the difference—$4,125. ($5,500 - $1,375 = $4,125)

There is a third possibility that we need to examine. Tom’s 40 year-old wife, Brenda, is a stay-at-home mom, and Tom and Brenda would like to make a deductible traditional IRA contribution for her. Although the maximum deductible contribution that can be made for the non-working spouse of an active participant *could* be reduced, the deduction won’t be reduced in this case because the applicable dollar amount in 2015 for a non-working spouse of an active participant is $181,000, meaning that Tom’s adjusted gross income would need to be more than $183,000 to affect her deductibility. The formula into which the numbers would be substituted in the case of a non-working spouse of an active participant is our first formula.

By applying Tom’s AGI and the maximum contribution to the formula, we can see that a maximum traditional IRA contribution for Brenda is completely deductible:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction of Deduction | = | Maximum contribution | x | AGI – applicable dollar amount  $10,000 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $0 | = | $5,500 | x | $103,000 – 183,000  $10,000 |

Notice that the formula you’re looking at is NOT a formula for determining the tax-deductibility of a traditional IRA contribution. It is the formula for determining an active participant’s (or spouse’s) REDUCTION in his or her traditional IRA deductibility.We will see later that if an individual’s contribution is not tax deductible, he or she should probably be advised to place the non-deductible contribution into a Roth IRA rather than make a non-deductible contribution to a traditional IRA. As we will discuss when we examine Roth IRAs, that alternative is generally more desirable than making non-deductible traditional IRA contributions.

Furthermore, it is important to understand that active participation in an employer plan does not affect an individual’s ability to *contribute* to a traditional IRA nor does it lessen the allowable amount that may be contributed. Active participation affects and may reduce the *deductibility* of traditional IRA contributions.

Some married individuals may choose to file separate federal income tax returns. Doing that, however, has an adverse effect on the deductibility of the active participant’s traditional IRA contribution. If a married individual files a separate return, his or her applicable dollar amount is zero. What that means in terms of the tax deductibility of a traditional IRA contribution for an active participant is that the individual’s adjusted gross income must be less than $10,000 or all deductibility is lost. It is important to remember that, unlike certain tax deductions such as state taxes paid, an individual does not need to itemize his or her deductions in order to enjoy a tax deduction for a traditional IRA contribution.

#### Tax Credits

EGTRRA has brought about an additional tax incentive to make an IRA contribution—to either a traditional or Roth IRA—for some lower-income individuals. IRA contributions by individuals who meet certain adjusted gross income criteria result in a tax credit *in addition to* any other tax advantages.

The tax credit is a *nonrefundable* credit that is limited to the applicable percentage of traditional or Roth IRA contributions up to $2,000. A nonrefundable tax credit is a tax credit that is limited by the individual’s tax liability and acts to reduce the amount of federal income tax payable. If an individual has no income tax liability, or has an income tax liability that is less than the tax credit, a nonrefundable tax credit will not result in a payment from the federal government.

The percentage of the IRA contribution (up to $2,000 per individual) that is available as a tax credit depends upon the individual’s adjusted gross income and his or her tax filing status. The applicable percentages are as shown below:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Adjusted Gross Income[[1]](#footnote-1) | | | | | | |
| Joint Return | | Head of Household Return | | All Other Status | | Applicable |
| Over | Not over | Over | Not over | Over | Not over | Percentage |
| $0 | $36,500 | $0 | $27,375 | $0 | $18,250 | 50% |
| $36,500 | $39,500 | $27,375 | $29,625 | $18,250 | $19,750 | 20% |
| $39,500 | $61,000 | $29,625 | $45,750 | $19,750 | $30,500 | 10% |
| $61,000 |  | $45,750 |  | $30,500 |  | 0% |

For example, suppose Bill and Trudy Smith file a joint federal income tax return and have an adjusted gross income of $36,500. If Bill and Trudy each make a $2,000 contribution to a traditional or Roth IRA, they would receive a total tax credit of $2,000. ($4,000 x 50% = $2,000) If their adjusted gross income were $36,501, however, their total tax credit would be reduced to $800. ($4,000 x 20% = $800)

Since the tax credit is nonrefundable, Bill and Trudy would need to have a federal income tax liability at least equal to the tax credit in order to enjoy its full benefit. If they had a federal income tax liability of $1,000 and qualified for a $2,000 tax credit, the tax credit would completely offset their tax liability, but *they would not receive a refund of the additional $1,000*.

## Summary

Individual retirement accounts were authorized by Congress as part of ERISA to allow workers who were not covered under employer-sponsored retirement plans to make tax-deductible contributions to their own retirement plan. Since the passage of ERISA, IRAs have been expanded to include plans for non-working spouses, plans designed to provide education benefits, plans providing for non-deductible contributions but tax-free benefits, and certain employer-sponsored plans. In addition to the expansion of IRAs beyond the initial legislation’s intent, other legislation has significantly increased the maximum annual IRA contribution, added a provision permitting catch-up contributions for individuals age 50 and older and authorized a nonrefundable tax credit for IRA contributions by certain lower-income individuals.

Although the modest eligibility requirements that must be met to contribute to a traditional IRA make the vast majority of individuals eligible, the tax deductibility of contributions made by active participants in an employer-sponsored retirement plan may be reduced or eliminated depending upon their federal tax filing status and adjusted gross income.

## Review Quiz #1

1. Joan, age 35, is a stay-at-home mother who has no earned income; her husband’s earned income is $250,000. Although she is married she files a separate federal income tax return. What is the maximum contribution that may be made in 2015 to her spousal individual retirement account?

1. $0
2. $2,000
3. $5,500
4. $6,500

2. Bill Walters is a 52-year-old single client. His adjusted gross income in 2015 is $200,000, and he is not an active participant in an employer-sponsored retirement plan. What is the maximum 2015 traditional IRA contribution that he may deduct?

1. $0
2. $2,000
3. $5,500
4. $6,500

3. Shirley is a 32-year-old single woman who is the office manager in a downtown law firm. Her 2015 adjusted gross income is $68,000, and she is an active participant in her employer’s qualified retirement plan. The “applicable dollar amount” for active participants filing a single or head of household return in 2015 is $61,000. If she makes a $5,500 traditional IRA contribution in 2015, what amount may she deduct?

1. $5,500
2. $1,650
3. $3,850
4. $0

### Traditional IRA Tax Considerations—Accumulations

There are three primary factors that affect the value of any individual retirement account:

1. Contribution level
2. Duration of accumulation
3. Rate of return

In plain terms, the value of any account is based on the amount of money contributed, how long it has been in the account and the rate of growth that it enjoys. Obviously, those three factors are controlling for the traditional IRA value as well.

In addition to these three primary value-affecting factors, the growth in a traditional IRA is affected by two other factors:

* Tax-deductibility of contributions, and
* Tax deferral of earnings

It is reasonable to ask just how significant an impact is made by these two tax advantages. The answer is it may be *very significant*. Let’s take a look at the differences in accumulation resulting from these tax advantages. First we will consider the difference caused only by tax deferral and then we will take the tax deduction into account as well.

Suppose that your 25 percent tax bracket client had two accounts that were identical, except that one was tax-deferred and the other was subject to current taxation. If the client were to put $5,500 each year into both of those accounts and earn an average annual 6% return, the earnings difference would be substantial over time—even if he or she were to take a distribution from the tax-deferred account and pay taxes on the earnings after 30 years.

This is what the difference in after-tax earnings looks like at the end of various five-year periods, assuming the earnings are distributed **and all income taxes are paid** —and remember that this only reflects *tax deferral* on the earnings:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Effect of Tax Deferral Only | | | | |
| Years | Tax-Deferred Earnings\* | Currently-Taxed **Earnings**‡ | Dollar Difference | Percentage Difference |
| 5 | $4,023 | $3,943 | $80 | 2.0% |
| 10 | $16,383 | $15,626 | $757 | 4.8% |
| 15 | $39,899 | $36,956 | $2,943 | 8.0% |
| 20 | $78,345 | $70,307 | $8,038 | 11.4% |
| 25 | $136,770 | $118,639 | $18,131 | 15.3% |
| 30 | $221,931 | $185,638 | $36,293 | 19.6% |
| \*Actual earnings are shown reduced to reflect income taxes in a 25 percent bracket.  ‡Taxes due in a 25 percent bracket are assumed paid from the account each year. | | | | |

When looking at the chart showing the impact of tax deferral on earnings, it is important to bear in mind that the numbers reflect *earnings only*; they don’t reflect the total accumulation. Notice that there is a 19.6 percent increase in earnings over 30 years for the tax-deferred account after the client has taken a distribution and paid taxes on those earnings. The reason for the substantial difference between the two accounts is due to the client’s having paid income taxes each year over the 30 years on the currently-taxable account by withdrawing an amount from the account equal to the current income tax liability. Since that money was paid in taxes, it was not available to earn additional interest. That’s why tax-deferral makes a big difference.

The comparison between the currently-taxed account and the tax-deferred account assumes that the client remained in the same 25 percent tax bracket throughout the 30 years. Of course, we certainly don’t know that the client’s tax bracket won’t change. In fact, when the client takes the funds from the tax-deferred account, he or she may very well be retired and in a lower tax bracket, thereby making the difference even greater.

It should be clear that tax deferral is an important element in making an investment go further. Deferral of taxation on the *growth* of an investment is obviously important. Traditional IRAs, however, may also enable the owner to defer taxes on the *contribution* as well. In other words, the contribution may be deductible. Let’s look at the same analysis we just did, but this time we’ll compare a fully deductible traditional IRA with a contribution to a non-deductible, non-deferred account paying the same level of interest. In our analysis, both accounts will continue to earn 6%, and the client is still a 25% taxpayer. The only difference is that the effect of tax-deductibility is being added.

To compare these accounts fairly on an apples-to-apples basis, we need to start with the same amount of gross earned income—$5,500. In a fully-deductible account the entire $5,500 is contributed without any income taxes being paid. In the non-deductible, non-deferred account, your client must pay current taxes on the contribution in his or her 25% tax bracket as well as on the income produced by the investment. Payment of income taxes will reduce the $5,500 by $1,375 and leave $4,125 for investment purposes. ($5,500 *x* 25% = $1,375; $5,500 - $1,375 = $4,125)

When *tax-deductible contributions* and *tax-deferred growth* are combined, the results are still more startling. Even after taxes are paid on distributions from the tax-deductible, tax-deferred account in a 25 percent tax bracket, the account owner has 31.4 percent more money in that account—based on our assumptions—than in the currently taxed, non-deductible account after 30 years!

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Years | Tax-Deferred Account Value\* | Currently-Taxed **Account Value**‡ | Dollar Difference | Percentage Difference |
| 5 | $24,648 | $23,582 | $1,066 | 4.5% |
| 10 | $57,633 | $52,970 | $4,663 | 8.8% |
| 15 | $101,774 | $89,592 | $12,182 | 13.6% |
| 20 | $160,845 | $135,230 | $25,615 | 18.9% |
| 25 | $239,895 | $192,104 | $47,791 | 24.9% |
| 30 | $345,681 | $262,979 | $82,702 | 31.4% |
| \*Account value is shown reduced to reflect income taxes in a 25 percent bracket.  ‡Taxes due in a 25 percent bracket are assumed paid from the account each year. | | | | |

It is important to bear in mind that the comparison is designed only to illustrate the potential value of tax-deductibility and tax-deferral *under the assumptions made*. Different assumptions—assumptions concerning the contribution level, interest credited and tax bracket—would change the illustration, possibly significantly.

### Traditional IRA Tax Considerations—Rollovers

People frequently change jobs and often find, in so doing, that they will receive an unwanted distribution from the retirement plan maintained by their former employer. It is not that they don’t want the money; they usually don’t want the income tax liability that results from such a distribution. Fortunately, the rules generally permit the individual to transfer the distributed funds to another plan that will maintain the tax advantages the funds enjoyed in the earlier plan.

Similarly, the owner of a traditional IRA may choose to transfer his or her existing IRA funds to a new institution. The IRA may be currently invested in a particular mutual fund or other securities, and the owner may decide to move some or all of the funds to an institution providing principal and interest guarantees—or the owner may be willing to bear additional risk in the hope of achieving greater returns. In either case, the owner of the traditional IRA usually wants to avoid the need to take a taxable distribution from the IRA in order to implement changes in his or her investment strategy. The device used to maintain the favorable tax treatment of these funds is known as a rollover.

#### Eligible Rollover Distributions

A rollover is the transfer of a distribution from certain specified tax-advantaged plans that follows the rules set out in the Internal Revenue Code and Regulations and which enables the individual to maintain the former plan’s tax advantages with respect to the amount transferred. The distributions that may be rolled over are distributions from:

* A qualified plan (a pension plan, profit-sharing plan, 401(k) plan, etc.)
* A §403(b) tax-sheltered annuity
* An IRA, or
* An eligible §457 governmental plan

Distributions that are rolled over pursuant to these IRS rules are not includible in the individual’s gross income—thereby avoiding current income taxation—until they are received at some time in the future.

As we can see, distributions may be rolled over *from* several types of plans. However, there are some restrictions concerning the types of plans *to which* the funds may be transferred. The following table may clarify those restrictions:

|  |  |
| --- | --- |
| From These Plans. . . | To These Plans. . . |
| Qualified plan  (before-tax contributions only) | * Another qualified plan * A §403(b) tax-sheltered annuity * A §457 governmental plan (that agrees to separately account for eligible retirement plan funds) * A traditional IRA * A Roth IRA |
| Qualified plan  (after-tax contributions) | * A defined contribution plan (provided the plan separately accounts for after-tax contributions and transfer is direct trustee-to-trustee) * A traditional IRA |
| Eligible §457  governmental plan | * A qualified plan * A §403(b) tax-sheltered annuity * Another §457 governmental plan * A traditional IRA * A Roth IRA |
| §403(b) tax-sheltered annuity | * A qualified plan * Another §403(b) tax-sheltered annuity * A §457 governmental plan (that agrees to separately account for eligible retirement plan funds) * A traditional IRA * A Roth IRA |

|  |  |
| --- | --- |
| From These Plans. . . | To These Plans. . . |
| §403(b) tax-sheltered annuity  (after-tax contributions) | * A defined contribution plan (provided the plan separately accounts for after-tax contributions and transfer is direct trustee-to-trustee) * A traditional IRA |
| §403(b) tax-sheltered annuity (designated Roth accounts) | * Another 403(b) plan that accepts Roth rollovers * A Roth IRA |
| Traditional IRA  (deductible contributions only) | * A qualified plan * A §403(b) tax-sheltered annuity * A §457 governmental plan (that agrees to separately account for eligible retirement plan funds) * Another traditional IRA |
| Traditional IRA  (non-deductible contributions) | * Another traditional IRA |
| SIMPLE IRA  (during 1st 2 years of participation) | * Another SIMPLE IRA only |
| SIMPLE IRA  (after 1st 2 years of participation) | * Another SIMPLE IRA * A traditional IRA * A Roth IRA |
| Roth IRA | * Another Roth IRA |

By following the rules that are set out in the Code and Regulations, an individual can roll over an *eligible rollover distribution* from a qualified plan, a §403(b) tax sheltered annuity, a §457 governmental plan, a SIMPLE IRA or an IRA and continue to avoid paying current income taxes on the amount rolled over. Not every distribution, however, qualifies as an *eligible rollover distribution*.

#### Distributions Ineligible for Rollover

An eligible rollover distribution is any distribution made to an employee of the funds to his or her credit in a qualified trust EXCEPT for a distribution that is:

* Part of a series of substantially equal payments made over the employee’s life expectancy;
* Made for a specified period of 10 years or more;
* A required minimum distribution; or
* A hardship distribution.

Although most distributions from these various plans may be rolled over, provided they are eligible, that is not the end of the rollover story. Depending upon *how the individual handles the rollover*, it may or may not have other tax consequences.

#### Direct and Indirect Rollovers

There are two types of rollovers:

* Trustee to participant to trustee—known as an “indirect rollover,” and
* Trustee to trustee—known as a “direct rollover.”

A trustee can make the rollover directly to another trustee—for example, a pension plan trustee can send the funds directly to a traditional IRA trustee or to another qualified plan trustee by wire transfer or some other means—or it can pay the funds to the individual. Unfortunately, when non-IRA rollover funds are paid to the individual for subsequent rollover to the new plan trustee, they come with some serious strings attached.

##### Mandatory Withholding

At the outset of this discussion on trustee-to-trustee rollovers and rollovers in which payment is initially made to the individual, we need to make a distinction between rollovers from an IRA and rollovers from plans other than IRAs.

Any distribution to a participant from a qualified plan, §457 governmental plan or §403(b) tax-sheltered annuity other than a required minimum distribution (RMD) requires that the trustee of the distributing plan withhold 20 percent of the distribution for taxes even if that distribution will be rolled over to another plan by the participant. To make things even worse, the amount withheld for taxes is itself considered a distribution and subject to taxation and premature withdrawal penalties. In contrast to the required withholding required in the case of distributions from qualified plans, rollovers from traditional IRAs are not subject to the mandatory 20 percent withholding, even when the individual receives a distribution directly.

Let’s consider an example of a rollover involving the mandatory withholding. Suppose Bob White was a participant in his firm’s 401(k) plan and had a vested account balance of $100,000. If the account balance was distributed to Bob, the plan trustee would be required to withhold $20,000 and pay the $80,000 balance to Bob.

If Bob chose to roll the funds in the qualified plan account over to another plan or to a traditional IRA, he would only have the $80,000 distributed to him with which to do that. Alternatively, he could remove $20,000 from his savings and add it to his net distribution to bring the funds back up to the amount that he could roll over. The $20,000 withheld amount would be shown on his tax form at year-end, and if Bob used his personal funds to make up the amount of the distribution that was withheld, he could recover the funds taken from his savings in a tax refund when he filed his annual federal income tax return.

Whichever approach that Bob took, he must roll over the funds within 60 days of the distribution in order to avoid inclusion of the distribution in his income.

If Bob didn’t have the $20,000 available or chose not to make up the withheld amount and just rolled over the $80,000 within the required 60 days, he would avoid having to include the amount rolled over in his income. Unfortunately, however, the $20,000 withheld by the plan trustee is considered a taxable distribution to Bob and, if Bob is less than age 59½, the distribution would be considered premature and subject to a 10 percent penalty tax.

Assuming that Bob was in a 25 percent federal income tax bracket, he could have an unintended federal income tax liability of $7,000 resulting solely from the rollover. The bulk of that tax liability—$5,000—is attributable to the federal income tax due on the withheld $20,000. ($20,000 x 25% = $5,000) The remainder of Bob’s $7,000 tax liability is due to the 10 percent premature withdrawal tax penalty levied against the withdrawal that he must include in his income. ($20,000 x 10% = $2,000) In addition to the federal income tax liability, Bob could also have to pay state income taxes on the amount withheld.

#### Avoiding Rollover Withholding

The way to avoid that mandatory withholding of taxes on rollover funds from various tax-advantaged plans and the resulting tax liability is fairly straightforward. It is a trustee-to-trustee rollover, a transfer of funds made directly from the trustee of the existing plan to the trustee of the new plan. By using a trustee-to-trustee rollover of the funds from either a qualified plan, §457 governmental plan or §403(b) tax-sheltered annuity, the participant can avoid the mandatory 20 percent withholding by the transferring trustee. The entire account balance can be quickly and efficiently transferred from one plan to another.

#### Indirect Rollovers Subject to Timing and Frequency Limitations

As noted just above, mandatory withholding does not apply to rollovers or transfers from existing traditional IRAs to new IRAs. There are other rules, however, to which an IRA-to-IRA rollover is subject when the funds are distributed to the individual first:

* Rollover may only be done once in any one-year period; and
* Rollover must be completed within 60 days of the distribution.

There is no age limit beyond which a rollover is prohibited. However, when an individual makes a rollover contribution to a traditional IRA after the taxable year in which he or she attains age 70½, distribution of the owner’s interest—required minimum distributions, in other words—must begin by the close of the taxable year of the rollover. Beginning in 2015, all of an individual’s IRAs are considered a single IRA for purposes of the once-a-year IRA rollover rules. Thus, if an IRA owner has two IRAs, taking a distribution from one and rolling it over will cause the owner to be prohibited from rolling funds over from either IRA for the following 12 months.

These rules can be avoided by using a trustee-to-trustee rollover. When an IRA is rolled over into another IRA on a trustee-to-trustee basis, there is no 60-day period involved for the funds’ reinvestment. Additionally, there is no limit to the number of times during the year that the IRA may be rolled over—as long as the individual does not receive the funds.

Until the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the maximum amount that could be rolled over was the amount of the distribution that would be includible in income if it were not rolled over. As a result of that rule, any after-tax contributions could not be rolled over since they would be received tax-free by the individual.

#### EGTRRA Permits Rollover of After-Tax Contributions

Because of EGTRRA, certain rollovers of after-tax contributions are permitted. For distributions after December 31, 2001, after-tax contributions made to a qualified plan can be rolled over from the qualified plan to a:

* Traditional IRA; or
* Defined contribution plan (only if the plan separately accounts for after-tax contributions and the funds are transferred in a direct trustee-to-trustee transfer).

Although after-tax contributions from a qualified plan may be rolled over to a traditional IRA, the reverse is not true: after-tax IRA contributions may not be rolled over to a qualified plan. They may be rolled over to another IRA, however.

EGTRRA also provides an exception to the 60-day rule with respect to the time limit for rollovers. Prior to the passage of EGTRRA, the 60-day time limit was strictly enforced by both the IRS and the courts—regardless of the reason for missing the deadline. EGTRRA provides a hardship exception to the 60-day rule, under which the Secretary of the Treasury may waive the rule where its enforcement would be against equity or good conscience. Examples of circumstances that could result in a waiver of the rule include disasters or other events beyond the individual’s control.

## Summary

One of the principal methods used by government to encourage economic actions is the granting of favorable tax treatment; owners of traditional IRAs, as a result, enjoy both the tax-deductibility of contributions and the tax-deferral of income. These tax advantages, because they permit the earning of income by funds that would otherwise have been used to pay income taxes, can result in significant increases in the level of IRA funds accumulated.

An individual’s investment objectives, time horizon and risk tolerance may change over time, and IRAs enable owners to change their investments to reflect those changes. A traditional IRA owner may roll his or her traditional IRA funds over to another IRA, a qualified plan, a §403(b) tax-sheltered annuity or to certain §457 governmental plans. Provided the rollover meets the requirements of the Internal Revenue Code, the funds will avoid current inclusion in income and will retain their tax deferral.

## Review Quiz #2

1. Helen, age 72, received a $20,000 required minimum distribution in 2015 from her traditional IRA. Since she has sufficient income from other sources, she wants to rollover the distribution to another traditional IRA. What is the maximum amount she will be able to rollover, assuming she uses no savings to make up for any mandatory withholding?

1. $0
2. $20,000
3. $16,000
4. $4,000

2. Peter, age 47, was terminated from his employer’s service. At the time of his termination, his vested account balance in his employer’s qualified plan was $200,000. He received a check from the plan trustee fully distributing the available funds, which he immediately rolled over to a traditional IRA. Assuming Peter is in a 25% tax bracket and does not make up any funds withheld by the trustee, what is his income tax liability resulting solely from the rolled over distribution?

1. $0
2. $10,000
3. $14,000
4. $4,000

3. Edna was a long-term employee whose vested account balance in her employer’s retirement plan at the time of her separation from service is $200,000, which is comprised of $100,000 in pre-tax contributions, $20,000 in after-tax contributions and $80,000 in earnings. She wants to roll over as much as possible into a traditional IRA. What is the maximum amount that may be rolled over?

1. $180,000
2. $200,000
3. $100,000
4. $20,000

## Distribution

The final piece of the traditional IRA tax puzzle involves the tax treatment given to distributions from a traditional IRA. Let’s focus our attention on that now. It is helpful to keep the following principle in mind: because IRAs are intended to serve as retirement accumulation vehicles, the tax laws are designed to:

1. discourage early distributions; and
2. require that distributions begin (and thus, be subject to tax) by a certain age.

### Premature Distributions

In order to ensure that traditional IRAs are used for the purpose they were designed—specifically to accumulate retirement savings—Congress imposed a limitation on their liquidity by specifying a penalty for premature distributions. Although there are certain exceptions, the general rule is that the individual must be at least age 59½ before receiving a distribution from a traditional IRA in order to avoid a premature distribution penalty .

The premature distribution penalty is 10 percent of the amount of the distribution that is includible in the individual’s gross income. In many cases, the amount of the traditional IRA distribution that would be includible in the individual’s gross income is the total amount of the distribution. However, there may be parts of a distribution that are not includible. In a traditional IRA, a distribution that would not be includible in the individual’s gross income is the distribution of a non-deductible contribution.

#### Premature Distributions Avoiding Tax Penalty

There are certain premature distributions—distributions made before the owner reaches age 59½— to which the 10 percent penalty tax doesn’t apply. Those distributions include distributions:

* Made at the individual’s death;
* Attributable to the individual’s disability;
* Made for medical care to the extent allowable as a medical expense deduction;
* Made for the payment of health insurance premiums by unemployed individuals;
* Made to pay qualified higher education expenses for the individual, his or her spouse, child or grandchild;
* Considered “first-time homebuyer distributions” up to a lifetime maximum of $10,000; or
* That are part of a series of substantially equal periodic payments made for the life of the individual or the joint lives of the individual and his or her beneficiary

In addition to any applicable premature distribution tax penalty, distributions from a traditional IRA are taxed as follows:

* Deductible contributions and all earnings are taxed as ordinary income, and
* Non-deductible contributions are tax free and distributions in which they are included are given annuity rule tax treatment

#### Pro-Rata Distribution of Non-Deductible Contributions

The general rule concerning taxation of traditional IRA distributions is that if the funds have not already been taxed, they are taxable. Distributed after-tax contributions made to a traditional IRA are received tax-free as a return of basis, and the remainder is taxable. A formula is used to determine how much of any distribution should be considered a return of those after-tax contributions. That formula is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Unrecovered non-deductible contributions  Total IRA balance (at year end of the year of the distribution)+ Distribution amount | x | Distribution amount | = | Tax-free portion of distribution |

Let’s look at an example. Assume that the client has a traditional IRA balance at year-end of $35,000, $2,000 of which is non-deductible contributions, and he took a $5,000 distribution during the year. All that we need to do is plug the numbers into the formula to see how much of the $5,000 distribution would be considered tax-free as a return of his non-deductible contributions.

By simply substituting the applicable numbers into the formula, we can see that the tax-free portion of the client’s distribution amounts to $250. The substitution looks as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $2,000  ($35,000 + $5,000) | x | $ 5,000 | = | $250 |

As we can see from the formula, the underlying tax philosophy is to distribute the non-deductible contributions on a pro-rata basis over the life of the account. There is a tax drawback to the use of a traditional IRA. The disadvantage is that any capital gains treatment that the gain on the underlying investment might otherwise qualify for is lost. So, any earnings distributed from a traditional IRA are subject to ordinary income tax, not capital gains treatment.

### Required Distributions during Owner’s Lifetime

We’ve talked about the age that IRA owners need to be in order to avoid premature distribution tax penalties on distributions, but we haven’t yet discussed at what age distributions *must* be taken from a traditional IRA. For clients that can afford it, it would be nice if the tax deferral of contributions and earnings offered by traditional IRAs could continue indefinitely. Unfortunately, that is not the case; there is a day of income tax reckoning when those previously-deducted traditional IRA contributions must be withdrawn.

The Internal Revenue Code requires that minimum distributions from a traditional IRA begin no later than the owner’s age 70½. Actually, the law permits the individual to delay taking the first required minimum distribution until April 1st of the year following the year in which he or she turns age 70½. This date (on which distributions must begin) is known as the “required beginning date.” Advisors generally counsel their clients not to wait until the following year, however, because the client must then take a second distribution by December 31st of that same year. As a result, two taxable distributions will occur during the same year—a situation that many people would choose to avoid. As we will examine in the next lesson, distributions need never be taken from a Roth IRA during the owner’s lifetime.

It is important that the difference between the rules governing required minimum distributions (RMDs) from traditional IRAs and the rules governing RMDs from employer-sponsored plans be understood. Required minimum distributions must begin from traditional IRAs when the owner becomes age 70½. Generally, for participants in employer-sponsored retirement plans, RMDs must begin on the *later* of the participant’s:

* Attaining age 70 ½; or
* Retiring from the employer maintaining the plan.

The required beginning date for receiving the first RMD from an employer-sponsored retirement plan is April 1 of the year following the participant’s reaching age 70½ or retiring.

#### Required Minimum Distribution Amount

In general, the minimum required distribution is equal to the value of the traditional IRA (or the account balance in the case of an employer-sponsored plan) divided by the individual’s remaining life expectancy. In fact, the federal government has made the determination of remaining life expectancy easy by publishing a Uniform Lifetime Table that governs most lifetime required minimum distributions by prescribing distribution periods depending on the age of the individual.

A failure to follow rules prescribed by the government is usually penalized by the imposition of additional taxes; this is no exception. The penalty for a failure to take a distribution at least equal to the RMD is 50 percent of the insufficiency. So, if the individual was required to take a minimum distribution of $15,000 and only took $5,000, the failure to take the other $10,000 would result in a tax of $5,000. ($10,000 x 50% = $5,000)

The Uniform Lifetime Table governing RMDs is as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Uniform Lifetime Table | | | | | |
| Age of Employee | Distribution Period | Age of Employee | Distribution Period | Age of Employee | Distribution Period |
| 70 | 27.4 | 86 | 14.1 | 101 | 5.9 |
| 71 | 26.5 | 87 | 13.4 | 102 | 5.5 |
| 72 | 25.6 | 88 | 12.7 | 103 | 5.2 |
| 73 | 24.7 | 89 | 12.0 | 104 | 4.9 |
| 74 | 23.8 | 90 | 11.4 | 105 | 4.5 |
| 75 | 22.9 | 91 | 10.8 | 106 | 4.2 |
| 76 | 22.0 | 92 | 10.2 | 107 | 3.9 |
| 77 | 21.2 | 93 | 9.6 | 108 | 3.7 |
| 78 | 20.3 | 94 | 9.1 | 109 | 3.4 |
| 79 | 19.5 | 95 | 8.6 | 110 | 3.1 |
| 80 | 18.7 | 96 | 8.1 | 111 | 2.9 |
| 81 | 17.9 | 97 | 7.6 | 112 | 2.6 |
| 82 | 17.1 | 98 | 7.1 | 113 | 2.4 |
| 83 | 16.3 | 99 | 6.7 | 114 | 2.1 |
| 84 | 15.5 | 100 | 6.3 | 115 | 1.9 |
| 85 | 14.8 |  |  |  |  |

In order to understand how the Uniform Lifetime Table is used, let’s look at the required minimum distributions for our client, Joe Bass. Joe has invested in a traditional IRA over the years and now must begin taking distributions. He was born on December 1, 1943 and is age 70½ on June 1, 2014. Although he must begin taking RMDs in 2014, he may defer the actual disbursement until April 1st of the year following the year in which he became age 70½. For our illustration, we will assume that he delays taking the disbursement until April 1, 2015, his required beginning date.

The account balance to which we relate the distribution period is the account balance on December 31st of the year prior to the year for which the distribution is being taken. Since Joe’s initial RMD is taken for the year 2014, even though he is deferring it until April 1st of the following year, the important account balance is the balance on December 31, 2013. We will suppose that Joe’s balance on that date is $300,000.

Since Joe’s balance on December 31, 2013 is $300,000 and he will be age 71 in the year for which the initial distribution is taken (2014), the minimum amount that needs to be distributed is $11,321—even if Joe defers receipt of the distribution until April 1, 2015. ($300,000 ÷ 26.5 = $11,320.75)

Because Joe deferred his initial RMD until his required beginning date (April 1st of the year following the year he became age 70½), he is required to take a second distribution by December 31st of the same year, based on his IRA account balance on December 31, 2014. If Joe’s traditional IRA account balance has earned interest at 5 percent, the balance in the account on December 31, 2014 is $315,000, and he will be age 72 in the year for which this second RMD is taken (2015). Because the distribution period for someone age 72 is 25.6, the balance must be divided by 25.6, producing an RMD of $12,305. ($315,000 ÷ 25.6 = $12,304.69) In each subsequent year, Joe must take an RMD at least equal to the account balance on the previous December 31st divided by the distribution period for his age in the distribution year according to the Uniform Lifetime Table. It should be clear that Joe Bass may certainly take a distribution that is *greater* than the RMD. He cannot take a distribution that is *less* than the RMD without incurring tax penalties.

### Required Distributions at Owner’s Death

Not only are distributions required during a traditional IRA owner’s lifetime, they are also required at his or her death. The rules governing required distributions at death vary, however, depending on whether the IRA owner died:

* Before the required beginning date; or
* On or after the required beginning date.

The required beginning datefor a traditional IRA is April 1st of the year following the year in which the owner became or would have become age 70½.

#### Death before an Owner’s Required Beginning Date

If a traditional IRA owner’s death occurs before the required beginning date, distributions must normally be made pursuant to the:

* Life expectancy rule; or
* Five-year rule.

##### Life Expectancy Rule

If a traditional IRA beneficiary elects to receive a distribution under the life expectancy rule, the interest in the IRA must be distributed over the beneficiary’s life or life expectancy and must start no later than the end of the calendar year immediately following the year of the IRA owner’s death. The life expectancy distribution rules are changed somewhat when the beneficiary is a surviving spouse.

###### Surviving Spouse’s Life Expectancy Rule

A surviving spouse beneficiary may choose to treat the deceased owner’s IRA as his or her own. However, if the surviving spouse does not choose to treat the IRA as his or her own and chooses, instead, to take distributions over life expectancy, such distributions must begin by the later of the end of the calendar year:

* Immediately following the calendar year in which the IRA owner died; or
* In which the owner would have reached age 70½.

##### Five-Year Rule

In an IRA distribution taken under the five-year rule, a beneficiary's interest must be completely distributed within five years following the IRA owner's death.

##### Surviving Spouse’s Election

Under certain circumstances, a surviving spouse may elect to treat the IRA as his or her own and be considered—for all income tax purposes—as the IRA owner. In order to make such an election, the surviving spouse:

* Must be the sole beneficiary; and
* Must have an unlimited right to make withdrawals.

If the spouse is eligible for and makes the surviving spouse’s election, withdrawals made by the spouse before the spouse’s age 59½ would be subject to a premature distribution tax penalty. Furthermore, RMDs from the traditional IRA must begin no later than April 1st of the year following the year the surviving spouse reaches age 70½.

#### Death On or After the Required Beginning Date

If a traditional IRA owner's death occurs on or after the required beginning date but before the entire IRA interest has been distributed, the balance of the IRA must be distributed at least as quickly as under the method of distribution in effect at the time of the traditional IRA owner’s death.

## Summary

A basic tenet of tax law (with certain exceptions that we will examine shortly) calls for the taxation of virtually all income. If taxation on income is deferred to some date in the future, the income deferred is generally taxable at the end of the deferral period. Traditional IRAs generally allow owners to enjoy a deferral on the taxation of *earned income* through tax-deductible contributions and of *investment income* through tax-deferral of earnings. When those amounts are subsequently disbursed, they are subject to income taxation at ordinary income rates. Any non-deductible contributions (but not the earnings on the nondeductible contributions) are received tax-free.

Distributions from a traditional IRA may begin, without penalty, at the owner’s age 59½. Distributions prior to attaining age 59½ are generally subject to an income tax penalty equal to 10 percent of the amount of the distribution includible in income. There are, however, certain exceptions that may apply.

Distributions equal to a prescribed minimum percentage must begin when the owner attains age 70½. A failure to take a sufficient distribution will result in tax liability equal to 50 percent of the distribution insufficiency.

## Review Quiz #3

1. Over the years, Ellen made before-tax and after-tax contributions to her traditional IRA and now, at her age 50, she is taking a complete distribution. What is the amount of the premature distribution tax penalty for which she may be liable, assuming no exception to the penalty applies, if her total traditional IRA distribution was $500,000, her before-tax contributions were $150,000 and her after-tax contributions were $50,000?

1. $50,000
2. $15,000
3. $45,000
4. $30,000

2. Carol made $80,000 of before-tax contributions and $20,000 of after-tax contributions to her traditional IRA over the years. She had not previously taken a distribution. Last year she took a distribution of $10,000 from the account. At the end of last year, Carol’s total IRA balance was $190,000. How much of the $10,000 distribution will Carol receive tax-free as a recovery of after-tax contributions?

1. $0
2. $1,000
3. $2,000
4. $10,000

3. Allen elected to receive the proceeds of his traditional IRA in equal periodic payments over a ten-year period. He died after receiving payments for six years, and his spouse was named as the sole beneficiary of the IRA. Which of the following options is available to the spouse beneficiary for distribution of the balance of Allen’s IRA?

1. The balance must be distributed at least as quickly as under the method of distribution elected by the deceased
2. The spouse may elect to treat the IRA as her own
3. The beneficiary may take the IRA balance in a lump-sum at the end of five years after the decedent’s death
4. The beneficiary may take the IRA balance over her life expectancy

# Chapter 2 Roth Individual Retirement Accounts

## Important Lesson Points

The important points addressed in this lesson are:

* Unlike a traditional IRA that offers current deductibility of contributions, Roth IRAs offer no deductibility but provide income tax deferral, tax-free distribution of contributions and possible tax-free distribution of earnings
* Eligibility for a Roth IRA is phased out at higher income levels and is eliminated at AGIs of $131,000 and $193,000 for single tax filers and joint filers, respectively
* Roth IRA owners are not required to take lifetime distributions from the account at any age and may make contributions beyond age 70½
* Qualified distributions from Roth IRAs are received entirely tax free
* Roth IRA owners receive distributions that are nonqualified on a FIFO basis, under which all tax-free contributions are distributed before any earnings are distributed
* Roth IRA distributions of gain made prior to age 59½ are subject to a premature withdrawal tax penalty unless specific exceptions apply
* Beginning in 2010, individuals with any AGI may convert a traditional IRA to a Roth IRA
* Traditional IRA funds converted to a Roth IRA are taxable at ordinary income rates generally in the year in which conversion takes place but are not subject to premature distribution tax penalties

## Chapter Learning Objectives

In this chapter we will look at the rules governing Roth IRAs. When you have completed this chapter you should be able to:

* Discuss the limitations imposed on Roth IRA eligibility and contributions;
* Explain the tax treatment of contributions to and distributions from Roth IRAs;
* Describe the conditions that must be met for a Roth IRA distribution to be considered a “qualified distribution”;
* Explain the distribution rules applicable to Roth IRA distributions upon the death of the owner; and
* Discuss the rules applicable to traditional to Roth IRA conversions occurring on or after January 1, 2010.

## Definition & Eligibility

When we looked at the traditional IRA, we saw that much of the tax benefit is enjoyed by the owner at the time that the deductible contributions are made. We are going to turn our attention now to a newer form of IRA whose principal tax benefits are enjoyed at the time funds are distributed to the owner rather than contributed by him or her.

The Taxpayer Relief Act of 1997 created additional classes of IRAs. The generally more important of these recent additions is the Roth IRA. Although there are significant differences between the tax benefits of Roth IRAs and traditional IRAs, the Roth IRA’s fundamental provisions and requirements are identical to those governing traditional IRAs.

Let’s begin our discussion of Roth IRAs with a definition. A Roth IRA is a personal retirement savings plan, funded by an annuity or trust/custodial account, which provides income tax deferral and may provide tax-free distribution of earnings. It does not provide for contribution deductibility. Eligibility for a Roth IRA is limited to individuals, regardless of age or qualified plan participation, whose income does not exceed certain adjusted gross income limits.

There are four significant differences between traditional IRAs and Roth IRAs that we need to be aware of:

1. No deductibility of Roth IRA contributions;
2. Possible tax-free earnings distribution of Roth IRA accumulations;
3. Roth IRA eligibility is limited, based on the individual’s adjusted gross income; and
4. Roth IRAs do not impose required distributions during the owner’s life.

In simple terms, Roth IRAs permit the deferral of taxation on earnings and offer possible tax-free distributions instead of deductible contributions. In addition, although virtually everyone may establish a traditional IRA, whose contributions *may or may not be deductible*, not everyone may be eligible for a Roth IRA. And finally, amounts contributed to and accumulating in a Roth IRA can remain in the account as long as the owner wishes; Roth IRAs do not impose required minimum distributions during an owner’s life.

We noted earlier that traditional IRA tax deductions are reduced or eliminated for active participants in employer-sponsored retirement plans. However, since Roth IRAs don’t offer tax deduction of contributions, they are not affected by an individual’s active participation in a qualified plan. The important limiting factor with respect to Roth IRA eligibility is the individual’s earnings. Specifically, the maximum contribution permitted to a Roth IRA or spousal Roth IRA is reduced or eliminated for certain high-income individuals.

## Limits on Contributions

The maximum amount an individual can contribute to a Roth IRA is the same as a traditional IRA: that is $5,500 (in 2015) or, if he or she is age 50 or older, $6,500. The maximum contribution that may be made to a Roth IRA is reduced, based on the individual’s adjusted gross income, according to the following formula:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Contribution reduction | = | AGI – applicable dollar amount  $15,000 ($10,000 if joint or married filing separate return) | x | Maximum contribution |

It’s interesting to note that the formula used to determine eligibility to make a Roth IRA contribution employs the same kind of language that we saw previously in determining the tax-deductibility of a traditional IRA for an active participant in a qualified plan.

Just as it was in that earlier formula, the “applicable dollar amount” in the Roth IRA formula is based on the individual’s filing status, as shown in the following chart:

|  |  |  |
| --- | --- | --- |
| Federal Income Tax Filing Status | Applicable Dollar Amount (2014) | Applicable Dollar Amount (2015) |
| Individual | $114,000 | $116,000 |
| Married, filing a joint return | $181,000 | $183,000 |
| Married, filing separately | $0 | $0 |

In order to better understand the impact of the individual’s adjusted gross income on his or her eligibility to make a Roth IRA contribution, we will consider several hypothetical clients.

John Ross is single, age 42 and has an adjusted gross income of $121,000. Since he is an active participant in his employer’s 401(k) plan and would be unable to deduct a traditional IRA contribution, he wants to make a Roth IRA contribution instead of, or in addition to, a traditional IRA contribution. To determine if John is eligible to make a Roth IRA contribution in 2015 and whether the maximum contribution is reduced, all we need to do is substitute John’s AGI in the formula:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Contribution reduction | = | $121,000 - $116,000  $15,000 | X | $5,500 | = | $1,833 |

It is easy to see that the maximum contribution that John can make to a Roth IRA in 2015 is $3,667 instead of the maximum $5,500 because his AGI is greater than the applicable dollar amount. By substituting the appropriate numbers in the formula, we can determine that the reduction in his contribution is $1,833. Since the maximum Roth IRA contribution is $5,500, a reduction of $1,833 means he can contribute $3,667. Even though John’s Roth IRA contribution is reduced, he can contribute the remaining $1,833 to a traditional IRA in 2015 as a *non-deductible* contribution.

We can make a similar calculation for John’s 45 year-old married brother, Tom, who has an adjusted gross income of $187,000. By substituting Tom’s AGI into the formula, we can see that he is eligible to make a Roth IRA contribution of $3,300. His reduction is $2,200.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Contribution reduction | = | $187,000 - $183,000  $10,000 | X | $5,500 | = | $2,200 |

If Tom chooses, he may make a traditional IRA contribution of the remaining $2,200. If he is an active participant in his employer’s qualified retirement plan, he will be unable to deduct the contributions. However, if Tom is not an active participant, the entire $2,200 contribution made to the traditional IRA will be deductible.

What the formula tells us is that single income tax filers can make a full Roth IRA contribution if their adjusted gross income is not in excess of $116,000, but the amount of maximum contribution is decreased for an unmarried individual with an adjusted gross income in excess of $116,000 and is eliminated at adjusted gross incomes of $131,000 or more. Similarly, joint filers can make a full Roth IRA contribution only if their AGI is $183,000 or less, and they become ineligible to make any Roth IRA contribution if their AGI is $193,000 or more.

Married individuals that choose to file separate income tax returns are ineligible to make any Roth IRA contribution if their adjusted gross income is $10,000 or greater.

Assuming that the individual is not ineligible to make a Roth IRA contribution because of his or her high income, and is not old enough to make a catch-up contribution, the maximum Roth IRA contribution he or she can make in 2015 (other than a catch-up contribution) is the lesser of:

* $5,500; or
* 100% of compensation.

The permissible maximum amount of the Roth IRA contribution, thus determined, is reduced by the amount of any traditional IRA contribution made by the individual for the same tax year. It is important to understand that the contributions made to a Roth IRA and a traditional IRA are considered to be the same for purposes of the maximum contribution permitted in any tax year. In other words, any contribution made by an individual to one will reduce the amount of contribution that can be made to the other.

We noted earlier in our discussion of traditional IRAs that no further contributions can be made once the individual reaches age 70½. In fact, at age 70½ the traditional IRA owner must begin taking at least a minimum distribution from these not-yet-taxed traditional IRA funds.

Unlike the situation that prevails with respect to traditional IRAs, a Roth IRA owner can continue to make Roth IRA contributions for as long as he or she lives and continues to be eligible by having earned income. Since taxes have been paid on the contributions, there is also no need to begin taking required minimum distributions from the Roth IRA at any age during the owner’s lifetime.

## Roth IRA Tax Considerations

As we know, the tax treatment given to Roth IRAs is also quite different from that given to traditional IRAs. While traditional IRA contributions may be tax deductible, depending on whether the individual is an active participant in an employer-sponsored plan and, if so, on the amount of his or her AGI, no part of a Roth IRA contribution is income tax deductible. All Roth IRA contributions are made with after-tax dollars.

Although Roth IRA contributions are not deductible, the contributions accumulate inside a Roth IRA on a tax-deferred basis—just as they do in a traditional IRA. And, we have already seen that tax deferral can make a big difference in accumulations. A Roth IRA provides an additional tax advantage, however: possible tax-free distributions of gain. Before these Roth IRA distributions are fully tax free, however, they must constitute “qualified distributions.”

### Qualified Distributions Tax-Free

A qualified distribution from a Roth IRA—a distribution that is entirely tax free—is one that is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA and:

* The individual is age 59 1/2 or older;
* The distribution is a qualified first-time homebuyer distribution;
* The individual is disabled; or
* The distribution is made to a beneficiary on or after the individual’s death.

As long as the Roth IRA has been in force for the required period, a distribution from it that meets one of the four tests will be entirely income tax free.

Let’s examine the impact of not having to pay income taxes on a Roth IRA distribution by comparing it to a currently-taxed account. Since neither the currently-taxed account contributions nor the Roth IRA contributions are tax deductible, we have assumed that $4,125 has been contributed each year to each 6% interest account—an amount that is $5,500 minus the income taxes in a 25% tax bracket—the results look like this.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Years** | **Tax-Deferred Account Value** | **Currently-Taxed** Account Value**‡** | **Dollar Difference** | **Percentage Difference** |
| 5 | $24,648 | $23,582 | $1,066 | 4.5% |
| 10 | $57,633 | $52,970 | $4,663 | 8.8% |
| 15 | $101,774 | $89,592 | $12,182 | 13.6% |
| 20 | $160,845 | $135,230 | $25,615 | 18.9% |
| 25 | $239,895 | $192,104 | $47,791 | 24.9% |
| 30 | $345,682 | $262,979 | $82,703 | 31.4% |
| ‡Taxes due in a 25 percent bracket are assumed paid from the account each year. | | | | |

Notice that the difference in the value of the account at the end of twenty years is almost 25 percent, and at the end of thirty years it’s 31.4 percent. There is another interesting phenomenon, however. We have seen these percentage increases before: the percentage increases are the same for both the traditional IRA that we discussed earlier and the Roth IRA that we are considering now. Assuming the same percentage growth and tax bracket assumptions, the result is identical to the client provided that:

1. The tax brackets at the time of contribution and distribution are the same; and
2. The amount contributed to the Roth IRA is the after-tax equivalent of the amount contributed to the traditional IRA.

In the comparison, the individual has contributed $4,125 to the Roth IRA; that amount is the $5,500 that would have contributed to the traditional IRA reduced by the taxes due in the individual’s 25 percent tax bracket.

There is one factor, however, that may make the Roth IRA more advantageous than a traditional IRA in any particular case. Specifically, the Roth IRA owner isn’t limited to a contribution of the *after-tax equivalent* of $5,500 of gross earnings in 2015. Instead, he or she can contribute the entire $5,500 to a Roth IRA. For the 25 percent tax bracket individual, that $5,500 after-tax Roth IRA contribution amounts to $7,333 in pre-tax earnings. ($7,333 x .75 = $5,500)

If the individual contributed the full $5,500 to the Roth IRA, the results, using the assumptions that we used earlier, could be a great deal different. Since this concept may be a little difficult to grasp, let’s consider an example.

Suppose that the individual contributed the entire $5,500 to a Roth IRA or to a traditional IRA. Assuming that the account owner is in a 25 percent tax bracket and earns a consistent 6 percent interest on both of the accounts each year, the difference in the distributed ***after-tax*** value would look like this:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $5,500 Annual Contribution, 25% Tax Bracket, 6% Annual Interest | | | | |
| Years | Traditional IRA After-Tax Value\* | Roth IRA **After-Tax Value**‡ | Dollar Difference | Percentage Difference |
| 5 | $24,648 | $32,864 | $8,216 | 33.3% |
| 10 | $57,633 | $76,844 | $19,211 | 33.3% |
| 15 | $101,774 | $135,699 | $33,925 | 33.3% |
| 20 | $160,845 | $214,460 | $53,615 | 33.3% |
| 25 | $239,895 | $319,860 | $79,965 | 33.3% |
| 30 | $345,681 | $460,909 | $115,228 | 33.3% |
| \*After-tax value in a 25% tax bracket  ‡Assumes that Roth IRA distribution is tax free as a qualified distribution | | | | |

Remember, we are comparing the distributed after-tax value of the two types of IRA. Since the Roth IRA qualified distribution would be tax free, the owner could expect—provided the assumptions were realized—to receive $32,864 if he or she received a qualified distribution at the end of five years, $76,844 at the end of ten years, etc. However, although the traditional IRA value would also be $32,864 at the end of five years, a traditional IRA distribution would be taxable. If the traditional IRA owner was in a 25 percent tax bracket when the distribution was made, the income tax liability as a result of the distribution would be $8,216. ($32,864 x .25 = $8,216) Since the traditional IRA owner must pay taxes on the distribution, he or she would receive $24,648 net of the income taxes. ($32,864 - $8,216 = $24,648)

It should be clear in this comparison that we are no longer comparing apples to apples. Although the contribution is the same $5,500 to the Roth IRA and the traditional IRA, the contribution to the Roth IRA costs more than a $5,500 contribution to a traditional IRA because income taxes must be paid on the funds used to make the Roth IRA contribution. Those taxes in a 25 percent income tax bracket amount to $1,833. The after-tax accumulation results, as you can see, are a consistent 1/3rd greater because the pre-tax earnings required to make the Roth IRA contribution are $7,333 instead of $5,500—or 1/3rd greater.

When making this type of analysis for a client, three important things must be kept in mind:

1. The growth rate we have used is entirely hypothetical and is used only to show the difference between the two IRA plans;
2. The analysis assumes that the income tax bracket is the same at the time of distribution as it is at the time of contribution; there is no way to be sure that will be the case; and
3. The distribution from the Roth IRA is assumed to be a qualified distribution and, therefore, tax free; at the time of distribution, the client may not meet the criteria for a qualified distribution.

### Non-Qualified Distributions Receive FIFO Tax Treatment

There is an additional tax advantage on distributions that Roth IRA owners enjoy, even when the distribution isn’t a qualified distribution: FIFO tax treatment.

Under FIFO tax treatment, all contributions to a Roth IRA are deemed to be distributed *before any earnings are distributed*. Since Roth IRA contributions are made with after-tax dollars, they are withdrawn tax free, even though earnings withdrawn in a distribution that is not a “qualified distribution” would be subject to income tax and, possibly, a premature distribution tax penalty. As a result of this favorable tax treatment, a Roth IRA owner can withdraw all his or her contributions from the account without incurring any income tax liability—and leave all of the earnings in the account continuing to enjoy tax deferral.

#### Non-Qualified Gain Distributions Subject to Tax Penalty

We noted earlier that a premature distribution from a traditional IRA would result in a 10 percent tax penalty. The 10 percent premature withdrawal tax penalty is assessed against the amount that must be reported as a taxable distribution. The same is true of a Roth IRA.

If an individual had contributed $10,000 to a Roth IRA and the value of the account was $15,000, $5,000 would be considered earnings. If the individual chose to withdraw all of the Roth IRA funds and the withdrawal did not meet the requirements for a qualified distribution, the premature withdrawal tax penalty would only be $500. Of the $15,000 in the Roth IRA, $10,000 would be received tax free as a return of after-tax contributions. The $5,000 balance is taxable earnings which must be reported. Since the Roth IRA owner must report $5,000 as a premature distribution, the tax penalty is 10 percent of that taxable amount, or $500.

Just as in the case of a traditional IRA, however, the penalty for a premature withdrawal from a Roth IRA is waived if the withdrawal is:

* Attributable to the IRA owner’s death or disability;
* Made for medical care to the extent allowable as a medical expense deduction;
* Made by unemployed individuals for the payment of health insurance premiums;
* Payment of qualified educational expenses;
* A qualified first-time homebuyer distribution; or
* Part of a series of substantially equal periodic payments made for the life or life expectancy of the individual or of the individual and a designated beneficiary.

### No Lifetime Required Distributions

Unlike traditional IRAs, existing tax laws do not mandate that minimum distributions be made from Roth IRAs at any time during the owner’s lifetime. Funds contributed to and accumulated within a Roth IRA can remain in the account as long as the owner wishes during his or her lifetime, even after age 70½. Because qualified Roth distributions create no tax liability for the Roth IRA owner (nor provide benefit for the federal coffers), there is no requirement that Roth IRAs must distribute their funds during the owner’s lifetime.[[2]](#footnote-2)

## Roth IRA Conversions & Transfers

Traditional IRAs were created in ERISA in the 1970s. When Roth IRAs were created in 1997, lawmakers included a provision in the law to allow a traditional IRA owner to convert his or her traditional IRA to a Roth IRA. Whether or not conversion is an appropriate strategy depends on the individual’s situation.

Up until 2010, an individual’s adjusted gross income could not exceed $100,000 in the year of conversion. If the individual’s AGI was more than $100,000, conversion from a traditional IRA to a Roth IRA was not permitted. Since January 1, 2010, a traditional IRA owner has been able to convert to a Roth IRA regardless of income.

When a traditional IRA owner converts to a Roth IRA, those previously-untaxed funds are subject to income taxation. However, if a traditional IRA owner made the conversion to a Roth IRA in 2010, he or she also enjoyed another income tax advantage: pro rata payment of income taxes on the amount converted over a two-year period. In other words, if $200,000 was subject to taxation because of conversion, only $100,000 is taxed in each of two successive years. The result is a reduction in the income tax liability. (This tax liability splitting applies only for conversions made in 2010.) Furthermore, although income taxes must be paid on the amount of the before-tax traditional IRA contributions and earnings converted to the Roth IRA, no premature withdrawal tax penalty applies.

## Roth IRA Death Benefit Distributions

As discussed earlier, the rules governing death benefit distributions under *traditional* IRAs vary depending on whether the IRA owner died before the required beginning date or later. However, there is no “required beginning date” for lifetime Roth IRA distributions. So, the rules governing *Roth* IRA distributions at the IRA owner’s death are identical to those applicable to a traditional IRA owner’s death before the required beginning date.

Thus, at a Roth IRA owner’s death, distributions must normally be made pursuant to the:

* Life expectancy rule; or
* Five-year rule.

### Life Expectancy Rule

If a Roth IRA beneficiary elects to receive a distribution under the life expectancy rule, the interest must generally be distributed over his or her life or life expectancy and must start no later than the end of the calendar year immediately following the year of the IRA owner’s death. The life expectancy distribution rules are changed somewhat when the beneficiary is a surviving spouse.

#### Surviving Spouse’s Life Expectancy Rule

A surviving spouse beneficiary may choose to treat the deceased owner’s Roth IRA as his or her own. However, if the surviving spouse does not choose to treat the IRA as his or her own and elects to receive distributions over his or her life expectancy, such distributions must begin by the later of the end of the calendar year:

* Immediately following the calendar year in which the IRA owner died; or
* In which the deceased owner would have reached age 70½.

### Five-Year Rule

In an IRA distribution taken under the five-year rule, a beneficiary's interest must be completely distributed within five years following the Roth IRA owner's death.

### Surviving Spouse’s Election

Under certain circumstances, a surviving spouse may elect to treat the Roth IRA as his or her own and be considered—for all income tax purposes—as the IRA owner. In order to make such an election, the surviving spouse:

* Must be the sole beneficiary; and
* Must have an unlimited right to make withdrawals.

If the spouse is eligible for and makes the surviving spouse’s election, withdrawals of gain made by the spouse before age 59½ would be subject to a premature distribution tax penalty. Furthermore, a tax-free distribution of gain must meet the criteria for a qualified distribution.

## Summary

After twenty-five years of traditional IRAs, Roth IRAs were introduced in 1997. Although Roth IRA owners forgo a current income tax deduction for their contributions, income taxation of their earnings is deferred and earnings may be tax free when distributed. Unlike traditional IRAs, to which virtually anyone may contribute, eligibility for a Roth IRA is phased out at higher income levels. Roth IRA eligibility is unaffected, however, by active participation in an employer-sponsored qualified plan.

The principal attraction of a Roth IRA is the possibility that all earnings may be received tax free in a qualified distribution. A qualified distribution from a Roth IRA is one that is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA and the individual is age 59½ or older, the distribution is a qualified first-time homebuyer distribution or is attributable to the owner’s death or disability. Traditional IRAs may also be converted to Roth IRAs; however the funds converted are includible in the owner’s income for tax purposes generally in the year of conversion.

## Review Quiz #4

1. Allen is age 45, files a joint federal income tax form with his wife and has an adjusted gross income of $189,000 in 2015. What is the maximum Roth IRA contribution he may make in 2015 when the applicable dollar amount is $183,000?

1. $0
2. $2,200
3. $3,300
4. $5,500

2. Audrey, age 42, contributed $30,000 to a Roth IRA she established eight years ago and has never taken a distribution. Her current account value is $45,000. How much income, if any, must she recognize if she withdraws $25,000?

1. $0
2. $5,000
3. $15,000
4. $25,000

3. Henry, age 47, took a total distribution from his Roth IRA he had established ten years ago. Since starting the IRA he has made contributions of $40,000 and has never taken a distribution. What is Henry’s income tax liability, if any, assuming the account value is $75,000 at the time of distribution, Henry is not disabled or a first-time homebuyer and is in a 25% income tax bracket?

1. $0
2. $3,500
3. $8,750
4. $12,250

# Chapter 3 Individual Retirement Account Funding

## Important Lesson Points

The important points addressed in this lesson are:

* IRAs may be funded by commercial annuities or may employ a custodial account
* IRA funds contributed to a custodial account may be invested in a wide range of financial vehicles, including mutual funds, CDs, stocks, bonds and certain gold and silver coins
* IRA funds may not be invested in life insurance contracts or certain collectibles, such as antiques or art
* Annuity funding of IRAs should be considered only when the non-tax benefits of the annuity are desired

## Chapter Learning Objectives

In this chapter we will look at the rules governing the financial products in which IRA assets may be invested. When you have completed this chapter you should be able to:

* Discuss the financial vehicles in which IRA assets may be invested;
* Identify the investments in which IRA assets may not be allocated;
* Describe the additional benefits provided by investing IRA assets in an annuity; and
* List the factors that should be considered in determining the suitability of a variable annuity as a client’s IRA investment.

## IRA Investment Options

Before November, 1978, an individual wishing to fund an IRA could use various vehicles, such as a mutual fund, a savings account, stocks, bonds, an annuity, a retirement bond or an endowment contract. Effective November 6, 1978, IRA regulations prohibited the use of life insurance in any form in IRAs. In addition, the sale of retirement bonds was suspended as of April 1982.

However, there remain two basic funding approaches for individual retirement accounts:

1. Trust or custodial account; and
2. Annuity.

An IRA owner can opt for funding his or her account with an annuity or may use a trust or custodial account through which other products can be purchased.

### Trust or Custodial Account IRA Funding

The trust or custodial account must be one that is established to provide benefits for the IRA owner and his or her beneficiaries. These permitted funding approaches apply to both traditional and Roth IRAs.

Some of the non-annuity products that are normally used to fund individual retirement accounts through a custodial account include:

* Mutual funds;
* Certificates of deposit & other traditional savings vehicles;
* Stocks;
* Bonds; and
* Certain gold and silver coins.

As we can see, there are many funding vehicles available to the IRA owner. In fact, it is easier to identify those investments that are not approved as IRA funding vehicles than to specifically list those that are.

#### Prohibited IRA Investments

The savings and investment products which are specifically prohibited as IRA funding vehicles are:

* Life insurance; and
* Collectibles, such as antiques, artwork, etc.

Of course, the other tax benefits normally associated with certain growth-oriented investments such as stocks and coins are lost when those investments are used to fund an IRA. Specifically, the growth in value of stocks and coins is normally associated with a gain in its value, rather than with dividends or interest. That gain could enjoy capital gains tax rates if the investment were not a part of an IRA. If an individual places IRA funds in investments normally eligible for capital gains treatment, any gains lose their identity as capital gains and—if distributed in other than a qualified Roth distribution—are subject to taxation at ordinary income tax rates when distributed from the IRA.

#### Separately-Paid Custodial Fees a Miscellaneous Itemized Deduction

When a trust or custodial account is used rather than an annuity, custodial fees normally must be paid each year or deducted from the account value. If these fees are separately billed by the trust and paid by the IRA owner, they may be claimed as an itemized miscellaneous deduction on the individual’s tax return. Furthermore, they will not be considered an excess contribution or reduce the amount which may be contributed to the IRA. In other words, an IRA owner may make his or her maximum IRA contribution and pay a custodial fee that might be $50 and deduct the entire amount.

### Using Annuities to Fund IRAs

Let’s turn our attention now to funding IRAs with annuities. For some people, the idea of putting tax-deferred funds into an already tax-deferred vehicle such as an annuity seems like taking coals to Newcastle; in other words, it isn’t necessary. However, before considering the *benefits* of using annuities to fund an IRA, let’s examine the *rules* regarding annuities in IRAs.

An annuity contract used in an IRA must be nontransferable by the owner. The practical effect of this ruleis that the annuity cannot be used as collateral for a loan. That means that an annuity used to fund an IRA cannot be used as security for a loan, either from the insurance company that issued it or from any other lender. An automatic premium loan would be prohibited and, if taken, could cause the plan to become disqualified. The plan would simply cease to be an individual retirement annuity. When a plan is disqualified, the funds that would be taxable if distributed at that time are immediately subject to income taxation and, if the individual is less than age 59½, a penalty equal to 10 percent of the amount includible in the individual’s income may be imposed for premature distribution.

The premium for the annuity used to fund an IRA must not be a fixed premium; instead, any annuity used to fund an IRA must have flexible premiums. The annual premium may not exceed the maximum permitted contribution. Any dividend payable under the contract must be used to reduce future premiums or purchase additional benefits.

If the IRA is a traditional IRA, a) the individual’s entire interest must be distributed by April 1st of the year following the year in which he or she attained age 70½, or b) distribution must begin by that date in accordance with required minimum distribution regulations.

Distributions from an IRA must comply with the incidental death benefit rule. This means that the IRA funds must be intended principally for distribution to the owner, and any distribution to a beneficiary must be only incidental. The owner’s entire interest must be nonforfeitable.

The principal benefit that accrues to the individual and his or her beneficiaries when an IRA is funded by an annuity is the availability of an income that can’t be outlived, although there are other benefits offered by annuities. The NASD (now FINRA) has published guidelines concerning the use of variable annuities to fund tax-qualified plans, including IRAs. According to those guidelines, a variable annuity should be recommended only when the individual is seeking the *non-tax benefits* of an annuity. The principle enunciated in those guidelines should also apply to the use of a fixed annuity as an IRA funding vehicle. (Note Variable Annuity Suitability Requirements below.)

#### Non-Tax Benefit #1: Annuity Death Benefits

One of the important annuity benefits relates to its death benefits. Annuities generally provide a death benefit that ensures the IRA owner that, before income benefits begin, his or her estate will receive at death no less than the cumulative contributions made to the plan, less any distributions taken. That provision applies regardless of any asset losses due to investment results. In variable annuities of more recent vintage, this death benefit guarantee has become even more attractive. Variable annuities have added a special enhancement to the death benefit by providing a step-up in the minimum death benefit periodically until the contract owner reaches a particular age.

For example, one variable annuity contract provides a step-up in the following way. On the 7th contract anniversary and every 7th subsequent contract anniversary, the minimum guaranteed death benefit is recalculated. The guaranteed death benefit may increase or remain the same as a result of this recalculation; the recalculation will never cause the death benefit to reduce from its previous level. The net result of this recalculation provision is to lock-in contract gains, for death benefit purposes, every seven years. Let’s examine the recalculation.

When the contract is purchased, the guaranteed minimum death benefit is equal to the contract owner’s initial purchase payment. The actual death benefit at any time may be greater than the guaranteed minimum death benefit, since it is equal to the greater of the cumulative premium and the current value at death. During the first 7 years, the guaranteed minimum death benefit will increase by any subsequent premium payments and decrease by any withdrawals.

On the 7th contract anniversary, the value of the contract is compared to the minimum death benefit, and the minimum death benefit may be increased. If the value of the contract is lower than the previous minimum death benefit, the guaranteed minimum death benefit stays at its current level. If the value of the contract is higher than the previous minimum death benefit, the guaranteed minimum death benefit is increased to equal the contract value on the recalculation date. This is a benefit that isn’t likely to be replicated in other types of investments.

Variable annuity issuers may offer more frequent death benefit step-ups or may offer a death benefit rollup under which the death benefit would be equal to no less than net premiums accumulated at a specified interest rate.

#### Non-Tax Benefit #2: Annuity Life Income

The other principal benefit of an annuity is its ability to provide a lifetime income to the IRA owner. Although an IRA could be invested in something other than an annuity—a mutual fund, for example—during the accumulation phase and an annuity purchased at the time of retirement, that strategy would cause the IRA owner to lose the possibly more-favorable guaranteed annuity rates that were available in the annuity contract at an earlier date. Although life insurance rates generally decline as mortality rates become more favorable over time, life annuity rates tend to become less favorable as mortality rates improve as a result of greater longevity.

As mortality rates improve, the insurance company’s cost to provide a lifetime income must increase since the income will be paid for a longer period. Continually improving mortality rates since the beginning of the 20th century make it easy to see the value in guaranteeing annuity rates. One of the greatest fears among Americans as they near retirement age, according to information from the U.S. Department of Health, Education and Welfare, is the fear of outliving their money. By funding an IRA with an annuity, that fear may be put to rest.

## Variable Annuity Suitability Requirements

When recommending the purchase or exchange of a deferred variable annuity to a customer, FINRA rules require that the recommendation be suitable. That suitability requirement also applies when such variable annuity purchase or exchange is recommended in connection with an IRA. Accordingly, when making a variable annuity recommendation a registered representative must:

* Make a reasonable effort to *obtain* and *consider* certain types of information specific to the customer, including the customer’s –
  + Age,
  + Income,
  + Financial situation and needs,
  + Investment experience and objectives,
  + Intended use of the deferred variable annuity,
  + Investment time horizon,
  + Existing assets,
  + Liquidity needs,
  + Liquid net worth,
  + Risk tolerance, and
  + Tax status;
* Have a reasonable basis for believing the customer has been informed of the material features of a deferred variable annuity, such as its –
  + Surrender charge,
  + Potential tax penalty,
  + Various fees and costs, and
  + Market risk;
* Have a reasonable basis to believe that the customer would benefit from certain deferred variable annuity features, such as –
  + Tax-deferred growth,
  + Annuitization benefits,
  + Death benefits, or
  + Living benefits;
* Make a customer suitability determination with respect to –
  + Investment in the deferred variable annuity,
  + Investments in the underlying subaccounts at the time of purchase or exchange, and
  + All riders and other annuity product enhancements and features; and
* In connection with any deferred annuity exchange that such exchange transaction is suitable for the customer, considering, among other factors, whether the customer –
  + Would incur a surrender charge,
  + Would be subject to a new surrender period,
  + Would lose existing benefits,
  + Would be subject to increased fees or charges, and
  + Has had another exchange within the preceding 36 months.

Additionally, many states have adopted the national association of insurance commissioner’s (NAIC) model act requiring that fixed annuity recommendations also meet suitability requirements.

## Summary

Individual retirement accounts—both traditional and Roth IRAs—may use either annuities or custodial accounts as funding vehicles. IRA funds contributed to a custodial account may be placed in a broad range of investments, including mutual funds, stocks, bonds, savings accounts, CDs and certain gold and silver coins. IRA owners may not invest their IRA funds in life insurance or certain collectibles, such as antiques or art.

Although commercial annuities are available to fund IRAs, they should generally not be used as a funding vehicle unless their non-tax benefits are desired.

## Review Quiz #5

1. Which of the following is specifically prohibited as an individual retirement account funding vehicle?

1. Gold coins
2. Life insurance
3. Preferred stock shares
4. Passbook savings accounts

2. Susan, age 44, funded her individual retirement account with a deferred annuity. During a period of unemployment, she pledged the annuity funding her IRA as collateral for a loan at her local bank. Which of the following statements concerning the loan transaction is correct?

1. The amount borrowed is taxable at long-term capital gains rates
2. Surrender charges are imposed by the insurer for loans collateralized by an annuity
3. The plan would be disqualified, causing the funds to be immediately subject to income taxation
4. The amount that may be borrowed is limited to no more than 50% of the account value at the time of the loan

3. Pat wants to use a deferred variable annuity as the investment vehicle to fund her traditional individual retirement account. In order for such a choice to be suitable, which of the following benefits should she be seeking?

1. Tax-deductibility of contributions
2. Tax-deferral of cash values until distributed
3. FIFO tax treatment of withdrawals
4. The non-tax benefits of the annuity

# Chapter 4 Education IRAs (Coverdell Education Savings Accounts)

## Important Lesson Points

The important points addressed in this lesson are:

* Education IRAs, renamed Coverdell Education Savings Accounts (ESAs), are designed to encourage saving to pay education expenses by offering tax deferral on earnings and possible tax-free distributions
* Eligibility to make ESA contributions is limited to individual tax filers with modified adjusted gross incomes less than $110,000 and joint tax filers with modified adjusted gross incomes of less than $220,000
* ESA contributions are non-deductible and limited to no more than $2,000 per year for any eligible designated beneficiary
* Eligible designated beneficiaries are children age 18 or younger or special needs beneficiaries at any age
* Contributions to an ESA grow tax deferred, and distributions from an ESA may be received tax free when used to pay qualified education expenses
* ESA funds may be rolled over to another qualifying beneficiary

## Chapter Learning Objectives

In this chapter we will look at the rules governing Coverdell Education Savings Accounts (ESAs). When you have completed this chapter you should be able to:

* Discuss the tax treatment of ESA earnings and distributions;
* Explain the eligibility requirements applicable to ESA contributors and beneficiaries;
* Describe the ESA contribution limits; and
* Discuss the rules governing ESA rollovers.

## Definition & Eligibility

An IRA that isn’t really a retirement account at all is one that was created to enable individuals to pay education expenses. Originally called an Education IRA, it is now known as a Coverdell Education Savings Account (ESA).

An ESA is defined as a trust or custodial account designed to enable the individual to save education funds on a tax-deferred basis and make tax-free withdrawals to pay for qualified education expenses. In 2002 and later, the amount that an individual can put into an ESA each year is $2,000.

Like most tax-advantaged programs that it has authorized, the Congress has prescribed certain eligibility requirements for the ESA. The maximum modified AGI that a joint tax filer can have and still take full advantage of the ESA is $190,000. In order for a single tax filer to take full advantage of an ESA, the individual’s maximum modified AGI cannot exceed $95,000. Eligibility is reduced for individuals whose modified AGI exceeds those amounts and is lost at modified AGIs of $220,000 and $110,000 for joint filers and single filers, respectively.

In earlier lessons, we have referred to the individual’s adjusted gross income as a limiting factor with respect to deductions or eligibility. In the case of ESAs, Congress has used the term “modified adjusted gross income.” Modified adjusted gross income refers to the exclusions for income derived from certain foreign sources or United States possessions. So, the modified adjusted gross income (MAGI) referred to with respect to Coverdell ESAs is adjusted gross income *plus* any excluded income from these two sources.

The maximum contribution amount is phased out for joint tax filers with modified adjusted gross incomes between $190,000 and $220,000. No ESA contribution may be made by a joint tax filer with a modified AGI of $220,000 or more or a single tax filer with a modified AGI of $110,000 or more.

## Limits on Contributions

The formula for calculating the reduction from the maximum ESA contribution for high-income joint filers is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction in Contribution (joint filer) | = | MAGI - $190,000  $30,000 | x | Maximum Permitted Contribution |

So, if a joint filer has a modified AGI of $205,000, the maximum contribution that he or she could make to a Coverdell ESA is $1,000.

We can see how the formula works to reduce the maximum ESA contribution by substituting the appropriate numbers into the equation:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Reduction in Contribution (joint filer) | = | $205,000 - $190,000  $30,000 | x | $2,000 | = | $1,000 |

For the individual’s modified adjusted gross income, we substitute $205,000; this gives us a fraction of $15,000/$30,000, or ½. Multiplied by $2,000, we have a reduction in the permitted contribution of $1,000. Since the maximum contribution is normally $2,000, the high-income individual is limited to making a contribution of no more than $1,000.

The same kind of calculation needs to be done for the high-income *individual* tax filer. A single tax filer with a modified adjusted gross income of $95,000 or less can make a maximum ESA contribution. Just as the maximum contribution was phased out for the *joint* tax filer client, it is also phased out for the *individual* filer client. In the case of an individual tax filer, however, the phase-out is over a $15,000 range, rather than the $30,000 range that applies in the case of joint tax filers. So, the formula for determining the reduction in the maximum permitted ESA contribution for a high-income individual tax filer is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction in Contribution (individual filer) | = | MAGI - $95,000  $15,000 | x | Maximum Permitted Contribution |

As you can see from the formula, the individual filer doesn’t completely lose the contribution unless his or her modified adjusted gross income exceeds $110,000. By making the same calculations that we made for the joint filer, we can calculate the high-income individual filer’s reduced maximum contribution.

### Eligible ESA Beneficiaries

Assuming that an individual is eligible to make a full ESA contribution, he or she may contribute $2,000 each tax year on behalf of each beneficiary. A beneficiary may be any individual who is age 18 or less. However, if the beneficiary is a *special needs beneficiary*, the “age 18 or less” requirement does not apply. Although a final definition of a special needs beneficiary has not yet been provided, a special needs beneficiary is expected to include individuals who require additional time to complete their education because of mental or emotional conditions.

The legislation that authorized ESAs and Roth IRAs does not require any relationship between the ESA donor and the beneficiary. So, an individual may make a $2,000 contribution for his or her child, grandchild or someone who is not related at all. In addition, a donor may establish multiple ESAs for many children, grandchildren or friends provided the contribution to each does not exceed $2,000 and the beneficiary, unless it is a special needs beneficiary, is not older than 18.

The contribution to a Coverdell ESA must be made to a trust or custodial account which may allocate the funds to a wide range of investments. However, the legislation specifically prohibits the purchase of life insurance with the assets of the ESA.

## Tax Considerations

Let’s turn our attention to the tax aspects of the ESA. Contributions made to an ESA are not tax-deductible; they are made with after-tax dollars. Contributions made to an ESA that are in excess of the amount that the individual is eligible to make are subject to a penalty. Although ESA contributions are not tax-deductible, the donor may incur a 6 percent excise tax for donations that exceed the maximum allowable. The excise tax will be levied each year for as long as the excess contribution remains in the account.

Since contributions are not tax-deductible and may incur an excise tax, the attraction of an ESA lies in its:

* Tax deferral of accumulations; and
* Possible tax-free distributions when used to pay qualified education expenses.

Although there are no tax benefits given to contributions to an ESA, there are definite benefits that apply to their accumulation and distribution. Specifically, taxes are deferred on the gain accumulated in the ESA, and distributions may be tax free.

### Tax-Free ESA Distributions

In order for distributions from an ESA to be excludable from income tax, the distribution received during the year must be used solely for the qualified education expenses of the designated beneficiary. Qualified education expenses are reduced by the amount of any such expenses taken into account in determining the American Opportunity Credit or the Lifetime Learning Credit.

There are two important limitations pertaining to ESA distributions. The first limitation on the distribution is that it must be used solely for qualified education expenses, and the second is that the distribution must be used for the designated beneficiary. If a distribution is taken from an ESA and fails to meet either of these requirements, the distributed gain would be subject to income tax.

Calculating the taxable portion of an ESA distribution that exceeds the beneficiary’s qualified education expenses requires that:

1. The total distributed earnings be multiplied by a fraction the numerator of which is the qualified education expenses paid (reduced by any adjustments for tax credits, etc.) and the denominator of which is the total amount distributed to determine the tax-free portion of the distributed earnings; and
2. The amount determined in 1 above must be subtracted from the total distributed earnings.

#### Qualified Education Expenses

Let’s turn our attention now to the meaning of “qualified education expenses” for ESA purposes. The expenses that are considered qualified education expenses for purposes of a Coverdell ESA are as shown below.

|  |  |
| --- | --- |
| **Higher Education Expenses Including:** | **Elementary and Secondary Education Expenses Including:** |
| Tuition | Tuition and fees |
| Fees | Academic tutoring |
| Books | Special needs services |
| Supplies | Books, supplies & other needed equipment |
| Equipment | Uniforms & transportation |
| Room and board | Other supplementary items & services |

In addition, qualified education expenses include amounts contributed to a qualified tuition program.

The term “qualified education expenses” seems to cover most of the expenses that a student is likely to encounter, including tuition, fees, books, supplies and, as long as the student is enrolled at least half-time, room and board.

#### Eligible Educational Institution

According to the ESA rules, these expenses must be incurred in an eligible educational institution. An “eligible educational institution” is any:

* College;
* Vocational school;
* University; or
* Other elementary, secondary or postsecondary institution.

The definition of “eligible educational institution” is remarkably broad and covers virtually all accredited public, nonprofit and proprietary educational institutions.

### Taxation of Excess ESA Distributions

Distributions of gain from an ESA may be includible in the recipient’s income if the distributions are not used solely for qualified education expenses for a designated beneficiary. One of the ways that a distribution would be includible in income is if the distribution exceeded the designated beneficiary’s qualified education expenses for the year. In such a case, part of the distributed gain would be includible.

In order to understand how the gain in an excess distribution would be taxed, let’s look at an example. Suppose a beneficiary took a $6,000 distribution from the ESA during the year. Instead of spending the entire $6,000 on qualified education expenses, his expenses only amounted to $4,500. Let’s further assume that the total contributions to the ESA were $4,000. The first step in determining the taxable portion of the distribution is to calculate the amount that would ordinarily be subject to tax. That would be the $6,000 distribution *less* the $4,000 investment in the contract. The result of that first calculation is $2,000.

The second step in our determining the taxable portion of the distribution is to determine the ratio of qualified education expenses to the total distributions. That is done by dividing the expenses—in this case, $4,500—by the distribution ($6,000). The result is .75 ($4,500 ÷ $6,000 = .75).

The third step is to multiply the result of the first calculation ($2,000) by the result of the second calculation (.75). That calculation yields $1,500, which is the amount of the excess distribution which is tax-free as a return of the investment in the contract.

The fourth, and final, step is to subtract the amount of the gain that is received tax-free ($1,500) from the distributed gain ($2,000). The result, i.e. $500, is the amount of the distributed gain that must be included in the designated beneficiary’s income. In addition to paying income tax on the $500, the designated beneficiary must also pay a penalty tax equal to 10 percent of the amount that is includible in income. The tax penalty would amount to $50.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Step 1** | ESA distribution:  Amount contributed to plan:  Difference (amount ordinarily subject to tax): | $6,000  – 4,000  $2,000 | | |
| **Step 2** | Ratio of qualified expenses to total distribution: | $4,500 $6,000 | = | .75 |
| **Step 3** | Amount of distributed gain received tax free ($2,000 *x* .75): | $1,500 | | |
| **Step 4** | Distributed gain subject to tax ($2,000 – $1,500):  Penalty on distributed gain ($500 *x* .10): | $500  $50 | | |

Sometimes, a designated beneficiary will choose not to attend school even though an ESA has been established for him or her. As a result, there may be funds in an ESA for the designated beneficiary at the time he or she attains age 30, the date at which the funds in the ESA must generally be used.

Except in the case of a special needs beneficiary, the funds that remain in an ESA must be distributed within 30 days of the beneficiary reaching age 30. Any amount that remains at the end of that 30-day period will be deemed to be distributed unless it is rolled over. Funds in an ESA may be rolled over to another ESA provided the designated beneficiary of the recipient ESA is a member of the family of the original designated beneficiary and has not yet reached age 30. The age requirement for a rollover beneficiary is disregarded in the case of a special needs beneficiary. Not unlike other IRA rollovers, the rollover to the recipient ESA must be made no later than 60 days after the date of distribution from the original ESA. And, only one rollover is allowed during any 12-month period.

## Summary

Education IRAs, now called Coverdell Education Savings Accounts, are trust or custodial accounts created exclusively for the purpose of paying the qualified education expenses of the trust beneficiary. In order to encourage savings for education, these ESAs offer tax deferral of fund growth and possible tax-free distribution when used to pay qualified education expenses. ESA contributions, however, are not tax-deductible.

ESA contributions may be made for a designated beneficiary age 18 or younger or for a special needs beneficiary at any age. Although the maximum annual contribution is $2,000, eligibility to make contributions is phased out at higher contributor income levels. ESA funds must generally be used for qualified education expenses by the time the designated beneficiary attains age 30. Except in those cases in which the designated beneficiary is a special needs beneficiary, any ESA funds not used by age 30 must be distributed within 30 days of the designated beneficiary’s reaching age 30. ESA funds may be rolled over to another ESA for the same beneficiary or for another beneficiary who is a member of the former beneficiary’s family.

## Review Quiz #6

1. Helen is a joint income tax filer who wants to make contributions to a Coverdell Education Savings Account (ESA) for her newborn granddaughter. What is the maximum contribution she can make to an ESA for her granddaughter in 2015 if her 2015 modified adjusted gross income is $205,000?

1. $0
2. $1,000
3. $2,000
4. $5,500

2. Barbara’s qualified education expenses at the university she plans to attend total $25,000. If she receives an American Opportunity Credit of $2,500, for which $4,000 of qualified education expenses were taken into account, what is the maximum tax-free distribution she may receive from her Coverdell Education Savings Account?

1. $25,000
2. $0
3. $21,000
4. $27,500

3. Arthur’s qualified education expenses amount to $30,000, and he has been granted an American Opportunity Credit of $2,500 (for which $4,000 of qualified education expenses are taken into account). If the total contributions made to his Coverdell Education Savings Account over the years amounted to $36,000 and he took a $40,000 distribution, how much of the distribution is taxable income to him?

1. $1,400
2. $0
3. $14,000
4. $4,000

# Chapter 5 Simplified Employee Pension IRAs

## Important Lesson Points

The important points addressed in this lesson are:

* Simplified employee pensions, better known as SEPs, are traditional IRAs into which employers may make deposits at levels far in excess of traditional or Roth IRAs
* SEPs provide a much simpler alternative to qualified retirement plans and are generally far less costly to install
* Employer contributions, which are discretionary, are tax-deductible to the employer and not included in the employees’ income
* In any year in which an employer makes a SEP contribution, an allocation must be made for any employee who is at least age 21, performed services for the employer in the year for which contributions are being made and earned at least $600 in 3 of the immediately preceding 5 years
* Employer contributions may not exceed 25 percent of compensation up to $53,000
* A SEP may not discriminate in favor of highly compensated employees, but the plan may be integrated with Social Security
* SEP contributions may be placed in a wide range of investments, but the plan may not invest in life insurance or certain collectibles
* Distributions of pre-tax contributions and earnings are taxable as ordinary income when received and subject to a 10 percent tax penalty if received prior to age 59½ unless the distribution is made pursuant to a specified exception
* After-tax contributions are received tax free upon distribution
* Required minimum distributions of SEP account balances must begin by age 70½
* Funds in a SEP may be rolled over according to the rules governing rollovers of traditional IRAs

## Chapter Learning Objectives

In this chapter we will look at the rules governing Simplified Employee Pension IRAs. When you have completed this chapter you should be able to:

* Identify the additional employer benefits associated with establishing a Simplified Employee Pension IRA compared to establishing a qualified plan;
* Explain the rules governing the employees that must be included in, and the employees that may be excluded from, a Simplified Employee Pension IRA;
* Discuss the rules applicable to employer and employee contributions to a Simplified Employee Pension IRA;
* Describe the tax treatment of Simplified Employee Pension IRA contributions and distributions; and
* Explain the rules applicable to Simplified Employee Pension IRA rollovers.

## Introduction

Employers have long understood that qualified retirement plans make good sense for both employees and employers. Among other benefits, they provide a way of humanely retiring older workers to make room for the promotion of younger workers. Furthermore, in a business environment in which many competitors make qualified plans available, the lack of a plan makes recruiting and retaining motivated employees more difficult.

Despite these and other obvious advantages of qualified plans, many employers have been reluctant to install a qualified retirement plan. Among the disadvantages of installing a qualified plan cited are:

* High levels of paperwork and bookkeeping needed;
* High costs of various consultants, such as lawyers, accountants and actuaries;
* Assumption of a fiduciary responsibility; and
* Contribution inflexibility.

In order to overcome some of the obstacles that employers saw to the establishment of a qualified retirement plan for their firms, Congress authorized a simplified employee pension (SEP) as an alternative to a qualified retirement plan. Similar, in some respects, to a profit sharing plan, a SEP couples design simplicity with a high level of contribution flexibility.

In reality, a SEP is nothing more than an employer’s agreement to contribute to traditional IRAs that are maintained by employees. The plan can be adopted by an employer by completing a fairly simple IRS form, rather than the much more complicated procedure involved in installing a qualified retirement plan. As in all tax-favored plans, the contributions must be on a nondiscriminatory basis. A SEP, because of its utter simplicity, is significantly easier and less expensive to install and administer than a qualified retirement plan. As a result, the need for the various consultants normally associated with the establishment of a qualified retirement is minimized, further reducing the employer’s cost.

When SEPs were initially introduced, employers with 25 or fewer employees were also permitted to establish plans that offer employees the opportunity to defer a portion of their income under a salary reduction SEP known as a SAR-SEP—an arrangement similar to a 401(k) elective deferral. These SAR-SEPs were replaced for employers seeking to allow employees to make elective deferrals for years beginning after 1996 by savings incentive match plans for employees, more commonly known as SIMPLEs. We will examine SIMPLE IRA plans in the next lesson. Although employers may not establish new SAR-SEPs after 1996, employers are permitted to continue to make contributions to existing SAR-SEPs, and employees hired after 1996 may participate in the salary reduction SEP. Elective deferrals under a SAR-SEP are treated much like 401(k) elective deferrals and are subject to the usual annual limitation on elective deferrals.

A SEP allows for higher contribution levels than traditional or Roth IRAs, has fewer restrictions than qualified retirement plans and, unlike SIMPLEs, there is no limit on the number of employees in the plan. Employees are immediately 100 percent vested in their accounts.

## Contributions

Let’s turn our attention now to an examination of the important characteristics of SEPs, beginning with the rules governing contributions.

Contributions made to a SEP by an employer are, in reality, made to the employees’ individual retirement accounts *that are owned by the employees*. The plan offers the typical employer and employee qualified plan tax advantages enjoyed on contributions:

* SEP contributions are deductible by the employer; and
* SEP contributions are excluded from the employee’s current income.

In addition, plan earnings are tax deferred until distributed. Contributions to a SEP may be made by the employer up to the time of its tax filing, including any extensions.

### Defined Contribution Plan Limits Apply

Similar to the flexibility found in profit sharing plans, employers may make SEP contributions on a discretionary basis and may choose, in any tax year, to make no contribution to the plan. SEPs are treated as defined contribution plans for the overall limits on employer contributions. Employer contributions in 2015 are, therefore, limited to no more than the lesser of 25 percent of compensation and $53,000.

For example, the maximum SEP contribution for an employee who earns $50,000 would be $12,500. ($50,000 x .25 = $12,500) The maximum contribution for an employee who earns $212,000 would be $53,000 (in 2015).

### Certain Employees Must Be Included

In any year in which an employer makes a contribution to a SEP, a contribution must be made for any employee—including a leased employee—who meets all of the following criteria and is not otherwise excluded. A SEP contribution must be allocated to an employee who:

* Is at least 21 years old;
* Has performed services for the employer during the year for which contribution is made; and
* Has earned at least $600 in at least 3 of the preceding 5 years.

Few employees may be excluded from an employer’s SEP. Those employees that may be excluded are employees that are:

* Covered by a collective bargaining agreement *if retirement benefits have been the subject of good faith bargaining*; and
* Non-resident aliens, if they received no income from the employer from U.S. sources.

Any employer establishing a SEP may impose fewer conditions for an employee to qualify to receive a contribution—the age may be reduced from 21 to 18, for example—but it may not make the requirements more stringent.

### SEP Integration Permitted

Although contributions may not discriminate in favor of highly compensated employees, SEPs can be integrated—i.e. there may be a permitted disparity in allocations—in accordance with the rules that apply to defined contribution qualified plans. An integrated SEP must provide for a uniform contribution disparity among all employees. To be uniform, it must use the same:

* Base contribution percentage; and
* Excess contribution percentage for all employees in the plan.

The result of integration is to take account of the portion of the Social Security tax paid by the employer that goes towards providing employees’ Social Security retirement benefits.

In addition to being uniform, an integrated SEP must be a defined contribution excess plan, which is to say that the rate of contribution allocations above the integration level is greater than the rate of allocations at or below the integration level. The disparity between the allocation above and below the integration level may not exceed the maximum excess allowance.

The maximum excess allowance is the *lesser* of 1 or 2 below, where:

1. is the base contribution percentage, and
2. is the *greater* of
   1. 5.7 percentage points, or
   2. the percentage equal to the portion of the OASDI Social Security tax in effect for the year attributable to old age insurance.

Integration, or permitted disparity, tends to be somewhat complicated when the concept is first approached. However, once explained, it is relatively easy to understand. To illustrate, let’s assume that, in a hypothetical SEP, the employer sets the integration level at $20,000 of compensation. The plan provides for contributions to be allocated as follows:

* 5% of compensation up to the integration level, and
* 10.7% of compensation above the integration level

In this case, the difference between the allocation above the integration level (10.7%) and the allocation at or below the integration level (5%) is 5.7%. That is the excess allowance.

We can apply this hypothetical permitted disparity to two employees to better understand its effect. Suppose that two covered employees are Jim Wilson and Eve Parker. Jim works in the mailroom and earns $27,000 a year; Eve is the assistant director of marketing and earns $50,000 a year. The contribution allocations under this plan would be as follows:

|  |  |  |
| --- | --- | --- |
|  | Jim Wilson  $27,000/yr. | Eve Parker  $50,000/yr. |
| Base contribution percentage (5% of compensation up to 20,000) | $1,000 | $1,000 |
| Excess contribution percentage  (10.7% of compensation in excess of $20,000) | + 749 | + 3,210 |
| Total allocation | **$1,749** | **$4,210** |
| Percentage of compensation | 6.5% | 8.4% |

### Employee Plan Contributions Permitted

In addition to *employer* contributions to the SEP IRA, an employee may also make deductible or non-deductible contributions similar to those made to a traditional IRA. The amount of annual contribution that the employee may make is limited only by the maximum amount permitted in that year and whether or not he or she is eligible to make catch-up contributions, as shown in the table below:

|  |  |  |  |
| --- | --- | --- | --- |
| Tax Year | Maximum Contribution | Maximum Catch-Up Contribution\* | Total Possible **Contribution**‡ |
| 2005 | $4,000 | $500 | $4,500 |
| 2006 – 2007 | $4,000 | $1,000 | $5,000 |
| 2008 – 2012 | $5,000 | $1,000 | $6,000 |
| 2013 – 2015 | $5,500 | $1,000 | $6,500 |
| \*Catch-up contributions may be made by individuals age 50 or older  ‡Amount shown includes catch-up contributions | | | |

#### Active Participant Rules Apply to Employee Contributions

An employee may take a tax deduction for contributions he or she makes to a SEP IRA under the same rules that apply to a tax deduction for contributions made to a traditional IRA. Specifically, if the employee is an active participant in his or her employer’s retirement plan, the deduction is phased out based on the individual’s adjusted gross income. An employee is considered an active participant in his or her employer’s SEP IRA *if any employer contribution is made during the taxable year*.

The reduction of the deductible amount of a SEP IRA contribution made by an employee is determined by using the following formula:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction of Deduction | = | Maximum deduction | x | AGI – applicable dollar amount  $10,000 ($20,000 for joint filer) |

The “applicable dollar amount” to be used in the formula depends upon whether the employee files a federal income tax return as a joint filer or as a single (or head of household) filer. The appropriate amounts to substitute into the formula are shown in the table below:

|  |  |  |
| --- | --- | --- |
| Taxable Years | Single or Head of Household Applicable Dollar Amount | Joint Filer Applicable Dollar Amount |
| 2006 | $50,000 | $75,000 |
| 2007 | $52,000 | $83,000 |
| 2008 | $53,000 | $85,000 |
| 2009 | $55,000 | $89,000 |
| 2010 | $56,000 | $89,000 |
| 2011 | $56,000 | $90,000 |
| 2012 | $58,000 | $92,000 |
| 2013 | $59,000 | $95,000 |
| 2014 | $60,000 | $96,000 |
| 2015 | $61,000 | $98,000 |

## Distributions

When examining SEP contributions, it is important to bear in mind that a SEP is simply an IRA to which higher contribution levels than those available in a traditional or Roth IRA are permitted. That fundamental identity as an IRA is also important to an understanding of SEP distributions.

When we talk about SEP distributions, we need to examine:

* Regular distributions;
* Premature distributions; and
* Required minimum distributions.

Let’s consider each of these types of distribution.

### Regular Distributions

As we have noted several times, a SEP is simply an IRA. An IRA is a personal, tax-favored savings plan designed to provide a benefit at retirement. As a plan designed to provide benefits at retirement, regular distributions are generally expected to begin no earlier than age 59½.

Distributions from a SEP that are attributable to plan earnings, employer contributions or tax-deductible employee contributions are taxable as ordinary income in the year distributed. Any character of the earnings on the underlying asset as capital gains is lost.

Non-deductible contributions are recovered tax free by the employee in a distribution as an investment in the contract. Determining the amount recovered tax-free requires a calculation similar to an annuity exclusion ratio calculation.

The formula for calculating the portion of a SEP distribution that is excludable from income as being attributable to non-deductible contributions is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Unrecovered non-deductible contributions  Total SEP balance + Distribution amount | x | Distribution amount | = | Tax-free portion of distribution |

If the employee had made a total of $10,000 of non-deductible contributions to the SEP and took a $5,000 distribution from it during the year, leaving a total SEP balance at year-end of $95,000, the tax-free portion of the distribution would be $500, as shown in the calculation below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $10,000  ($95,000 + $5,000) | X | $5,000 | = | $500 |

The balance of the distribution, i.e. $4,500, would be taxable as ordinary income.

### Premature Distributions

Not all distributions are made after the individual attains age 59½, however. Distributions from a SEP that are made before the employee reaches age 59½ are considered premature distributions and subject to a 10 percent tax penalty unless one of several exceptions applies. The 10 percent tax penalty for premature withdrawals is levied against the amount of the distribution *that is includible in the recipient’s income*.

The pre-age 59½ SEP distributions that avoid the premature withdrawal tax penalty are distributions that are part of a series of substantially equal periodic payments made for the life of the owner or the joint life of the owner and a designated beneficiary or are made:

* After the owner’s death;
* Attributable to the owner’s disability;
* For payment of health insurance premiums by an unemployed owner;
* For payment of qualified higher education expenses;
* For medical care to the extent deductible as a medical expense; or
* For the purchase of a first home (up to a $10,000 lifetime limit).

### Required Minimum Distributions

The Internal Revenue Code requires that minimum distributions from a SEP begin no later than the employee’s age 70½. Although the employee may delay taking his or her first minimum required distribution until April 1st of the year following the year in which he or she turns age 70½, i.e. the “required beginning date,” doing so means that the employee must then take a second distribution by December 31st of that same year. Since this would cause two taxable distributions to occur in the same year, it is generally a better idea to take the initial required minimum distribution in the year in which the employee attains age 70½.

Although a SEP is an employer-sponsored plan, the rules that govern required minimum distributions (RMDs) from SEPs are the same as the rules that apply to RMDs from traditional IRAs. Specifically, required minimum distributions must begin from the SEP IRA when the employee becomes age 70½, rather than on the *later* of the employee’s reaching age 70½ or retiring.

In general, the minimum required distribution is equal to the value of the employee’s SEP account divided by his or her remaining life expectancy. The Uniform Lifetime Table governs lifetime required distributions by prescribing distribution periods depending on the age of the individual. If the employee fails to take a distribution at least equal to the MRD a tax penalty applies equal to 50 percent of the insufficiency.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Uniform Lifetime Table | | | | | | |
| Age of Employee | Distribution Period | Age of Employee | Distribution Period | Age of Employee | | Distribution Period |
| 70 | 27.4 | 86 | 14.1 | 101 | 5.9 | |
| 71 | 26.5 | 87 | 13.4 | 102 | 5.5 | |
| 72 | 25.6 | 88 | 12.7 | 103 | 5.2 | |
| 73 | 24.7 | 89 | 12.0 | 104 | 4.9 | |
| 74 | 23.8 | 90 | 11.4 | 105 | 4.5 | |
| 75 | 22.9 | 91 | 10.8 | 106 | 4.2 | |
| 76 | 22.0 | 92 | 10.2 | 107 | 3.9 | |
| 77 | 21.2 | 93 | 9.6 | 108 | 3.7 | |
| 78 | 20.3 | 94 | 9.1 | 109 | 3.4 | |
| 79 | 19.5 | 95 | 8.6 | 110 | 3.1 | |
| 80 | 18.7 | 96 | 8.1 | 111 | 2.9 | |
| 81 | 17.9 | 97 | 7.6 | 112 | 2.6 | |
| 82 | 17.1 | 98 | 7.1 | 113 | 2.4 | |
| 83 | 16.3 | 99 | 6.7 | 114 | 2.1 | |
| 84 | 15.5 | 100 | 6.3 | 115 | 1.9 | |
| 85 | 14.8 |  |  |  |  | |

## SEP Rollovers

A rollover, except in the case of a rollover from a traditional IRA to a Roth IRA, is generally done in order to maintain the tax-favored nature of the funds involved. By rolling over the value of accounts to which before-tax contributions have been made, the account owner avoids inclusion of the distribution in his or her income in the year in which the rollover occurs. Furthermore, the rolled over funds will continue to enjoy tax deferral of growth.

Rollovers that are accomplished on a trustee-to-trustee basis are generally considered transfers and may be done as frequently as the owner wishes. Other rollovers involving a distribution to the employee have far more stringent rules. Specifically:

* Rollovers must be completed within 60 days of the distribution to the employee; and
* Only one rollover may be done in any 12-month period.

SEP IRA rollovers are subject to the same rules that apply to traditional IRA rollovers. The plans to which SEP funds may be rolled over depend upon whether the funds involved are before-tax contributions or after-tax contributions. A rollover of SEP IRA earnings and before-tax contributions may be made to:

* A qualified plan;
* A §403(b) tax-sheltered annuity;
* A §457 governmental plan (that agrees to separately account for eligible retirement plan funds);
* A traditional IRA; or
* A SEP IRA.

A rollover of SEP IRA after-tax contributions may be made to:

* A traditional IRA; or
* A SEP IRA.

## Summary

As a means of encouraging employers to offer retirement plans to employees without the complexity and costs of a qualified retirement plan, Congress authorized simplified employee pensions. Known as SEPs, these plans provide an individual retirement account for each eligible employee to which employers may make discretionary, tax-deductible contributions at levels far in excess of permitted traditional or Roth IRA contribution levels. In addition to employer contributions, employees may make tax-deductible or after-tax contributions. Account balances are 100 percent vested immediately. Employer contributions, which may be made up to the lesser of 25 percent of compensation or $53,000, may not discriminate in favor of highly compensated employees. The SEP may, however, be integrated with Social Security.

SEP distributions, to the extent derived from earnings or pre-tax contributions, are taxable as ordinary income. After-tax contributions are received tax free. Regular distributions may begin at age 59½ and must begin no later than age 70½. Distributions received prior to age 59½ are subject to a 10 percent tax penalty unless certain exceptions apply. A failure to take at least the required distribution at age 70½ and later results in a tax penalty equal to 50 percent of the insufficiency.

## Review Quiz #7

1. Patrick is a 52-year-old married employee who files a joint federal income tax with his spouse in 2015. His 2015 adjusted gross income is $113,000, and he is an active participant in his employer’s Simplified Employee Pension IRA. The “applicable dollar amount” for active participants filing a joint return in 2015 is $98,000. If he makes a $6,500 employee contribution in 2015 to his SEP IRA, what amount may he deduct?

1. $6,500
2. $4,875
3. $1,625
4. $0

2. Harriet, age 40, took a $25,000 distribution from her employer’s SEP IRA to purchase her first home. If she is in a 25% income tax bracket and all contributions to the plan were made by her employer on a before-tax basis, what is her total tax liability resulting from the distribution?

1. $7,750
2. $5,250
3. $8,750
4. $0

3. Audrey is a participant in her employer’s SEP IRA and has been making non-deductible contributions each year to the plan. Last year she took a distribution of $20,000 from the plan to pay for a European vacation. How much of her distribution must she include in her income if her total unrecovered non-deductible contributions were $50,000 and the balance in her SEP IRA account at the end of the year was $480,000?

1. $20,000
2. $18,000
3. $2,000
4. $0

# Chapter 6 SIMPLE IRAs

## Important Lesson Points

The important points addressed in this lesson are:

* Employers with no more than 100 employees earning $5,000 or more may establish and maintain SIMPLE IRA plans
* A SIMPLE IRA permits the small employer to avoid the costly setup and administrative charges characteristic of qualified retirement plans while still offering employees a plan to which elective deferrals and employer contributions may be made
* Contributions to a SIMPLE IRA involve elective contributions authorized by the employee in lieu of a cash distribution and mandatory employer contributions, all of which are made before taxes and enjoy tax deferral of gain
* Mandatory employer contributions to a SIMPLE IRA may be matching contributions or nonelective (i.e. non-matching) contributions and may be made up until the employer’s tax filing date, including extensions
* All SIMPLE IRA contributions and earnings are immediately nonforfeitable
* A nonrefundable tax credit for elective contributions to a SIMPLE IRA is available to certain lower-income employees, in addition to any other tax benefits arising out of the plan
* Distributions from a SIMPLE IRA are taxable as ordinary income in the year received
* Distributions from a SIMPLE IRA made earlier than the employee’s age 59½ are subject to a premature tax penalty unless specific exceptions apply
* The SIMPLE IRA premature distribution tax penalty is equal to 25 percent of the amount includible in income if received before the employee has two years of participation in the plan; on and after the first two years of plan participation, the penalty is reduced to 10 percent
* Required minimum distributions (RMD) from a SIMPLE IRA must begin at the time the employee reaches age 70½, even if still employed
* A SIMPLE IRA may be rolled over to another SIMPLE IRA at any time but may be rolled over to a traditional IRA only after the employee has been a participant for at least 2 years

## Chapter Learning Objectives

In this chapter we will look at the rules governing SIMPLE IRAs. When you have completed this chapter you should be able to:

* Describe the eligibility rules applicable to a SIMPLE IRA for employers and employees;
* Explain the rules governing SIMPLE IRA contribution sources and the limits applicable to annual additions;
* Describe the rules and restrictions governing rollovers from a SIMPLE IRA; and
* Discuss the taxation and rules applicable to SIMPLE IRA distributions.

## Definition & Eligibility

Although simplified employee pension (SEP) plans continue to be available, a particular type of SEP that permitted employees to make elective deferrals—known as a SAR-SEP or salary reduction simplified employee pension—could no longer be adopted after December 31, 1996. A new type of plan, designed to replace the SAR-SEP for small employers, became available for years after December 31, 1996.

This replacement plan is a SIMPLE plan. SIMPLE is an acronym that stands for Savings Incentive Match Plan for Employees. Congress authorized two basic types of SIMPLE plans:

* SIMPLE IRAs; and
* SIMPLE 401(k)s.

### SIMPLEs Offer Less Expensive Alternative to Qualified Plans

Similar to a SEP, a SIMPLE allows for higher contributions than permitted in a traditional or Roth IRA. The fundamental concept behind SIMPLEs is identical to that for SEPs: plan design and administrative convenience resulting in a plan that is relatively inexpensive to implement and produces employer savings when compared to traditional qualified plans.

### SIMPLEs Restricted to Small Employers

Unlike the rules governing the establishment of a SEP, eligibility to establish a SIMPLE is restricted to small employers. In the context of SIMPLE plans, a “small employer” is one with 100 or fewer employees earning at least $5,000 annually. For purposes of this small employer limitation, all employees employed at any time during the calendar year are considered, even those employees who are excludable or ineligible to participate.

In addition to regular employees that must be counted towards the 100 or fewer employees limitation, certain self-employed individuals who received earned income from the employer during the year must also be counted! However, an employer that ceases to be eligible—because of an increase in the number of employees, for example—after having installed and maintained a SIMPLE IRA for at least 1 year will continue to be treated as eligible for the following 2 years.

The eligible employer must not only meet the “small employer” definition, the SIMPLE IRA must generally be the employer’s sole retirement plan. A SIMPLE IRA is not subject to nondiscrimination or top-heavy rules.

In addition to the more economical administration of SIMPLEs, when compared to traditional qualified plans, an employer that employs a large number of part-time employees earning less than $5,000 may find a SIMPLE a more desirable plan than a SEP. Unlike a SEP, which must include any employee earning at least $600, a SIMPLE may generally exclude employees that are expected to earn less than $5,000. By excluding these part-time, lower-paid employees, the employer reduces required contributions and, compared to traditional qualified plans, the expense of many small accounts that are likely to be forfeited under the traditional plan’s deferred vesting schedule.

## SIMPLE IRA Contributions

Contributions to a SIMPLE IRA may come from two sources:

1. Elective contributions by employees; and
2. Employer contributions.

### Employee Elective Contributions

Employee elective contributions are made under a qualified salary reduction arrangement. A qualified salary reduction arrangement is a written arrangement of an eligible employer under which employees that are eligible to participate may elect to receive payments in cash or contribute them to a SIMPLE IRA and to which the employer may make matching contributions or nonelective contributions.

Except for certain catch-up contributions that may be made by employees age 50 or older, elective contributions to a SIMPLE IRA are limited to no more than $12,500 in 2015. Elective contributions to a SIMPLE IRA are counted in the overall limit on elective deferrals that may be made by any individual. The practical result of the overall limit on elective deferrals in this case is to reduce the amount that may be contributed by an employee who is covered under the plans of two employers. For example, an employee in a SIMPLE IRA would be able to make elective contributions in 2015 of $12,500. However, if that employee was also employed by an employer that maintained a 401(k) plan, he or she would be permitted only to defer an additional $5,500 in 2015 because of the $18,000 overall limit on elective deferrals.

Each year, each employee that is eligible to participate in a SIMPLE IRA can elect, during the 60-day period preceding that year, to participate in the salary reduction arrangement or modify the amount of the elective contribution.

#### Catch-up Contributions

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001authorizes certain salary reduction catch-up contributions that may be made *in addition to* the elective contributions limit. The catch-up amount for SIMPLE IRAs and SIMPLE 401(k) plans is smaller than it is for SEPs, 401(k) plans, 403(b) plans and 457 plans and is as shown in the table below:

|  |  |
| --- | --- |
| Year | Catch-Up Amount |
| 2005 | $2,000 |
| 2006 - 2014 | $2,500 |
| 2015 | $3,000\* |
| \*Indexed for inflation in $500 increments | |

In addition to elective contributions authorized in a salary reduction agreement, an employer that sponsors a SIMPLE IRA must make contributions each year that are either:

* Matching contributions; or
* Nonelective contributions.

### Matching Employer Contributions

If the employer elects to make matching contributions in any year, rather than nonelective contributions, the employer need make contributions *only* for those employees making elective contributions. The matching contributions must be at least equal to the lesser of:

* The amount of the employee’s salary reduction; or
* The applicable percentage of compensation for the year.

The applicable percentage of compensation is 3 percent unless the employer elects to use a lower percentage of not less than 1 percent. However, the employer may use a percentage less than 3 percent in no more than 2 years in the preceding 5-year period. If the employer elects a percentage less than 3 percent, it must notify the employees of its election within a reasonable period of time *before* the 60-day election period for electing to participate in the plan.

For years prior to the installation of the SIMPLE IRA, or in any year in which the employer made nonelective contributions, the applicable percentage is deemed to have been 3 percent. The maximum compensation limit of $265,000 under IRC Section 401(a)(17) does not apply to employer matching contributions. Therefore, the 3 percent match could reach the $12,500 maximum for employees with compensation of $416,667 in the year[[3]](#footnote-3).

### Nonelective Employer Contributions

In lieu of matching contributions, an employer may elect to make mandatory contributions under the nonelective contribution formula. If the employer makes such an election, it must make a contribution for every eligible employee, *whether or not the employee made an elective contribution*. The employer is required to make a contribution equal to 2 percent of the employee’s compensation. Since the compensation limit of $265,000 under IRC Section 401(a)(17) *does* apply to employer nonelective contributions, the maximum amount of nonelective contribution that an employer may make in 2015 is $5,300. ($265,000 x .02 = $5,300) If the employer elects to make nonelective contributions in any year, it must notify the employees within a reasonable time before the 60-day employee election period.

The employer’s matching and nonelective contributions may be made up to the employer’s tax filing date, including any extensions. The employee has an immediate nonforfeitable right to any elective contributions, employer contributions and any earnings in his or her account. Contributions may be allocated to a wide range of investments, but—as in other IRAs—they may not be invested in life insurance contracts or certain collectibles. Regardless of how invested, SIMPLE IRA contributions and earnings are tax-deferred until distributed.

#### Nonrefundable Tax Credit for Lower Income Employees

EGTRRA authorized an additional tax incentive to make an elective contribution to a SIMPLE IRA for some lower-income employees. SIMPLE IRA elective contributions by employees who meet certain adjusted gross income criteria result in a tax credit *in addition to* any other tax advantages.

The tax credit is a *nonrefundable* credit that is limited to the applicable percentage of elective contributions up to $2,000. A nonrefundable tax credit is a tax credit that is limited by the employee’s tax liability and acts to reduce the amount of federal income tax payable. If an individual has no income tax liability, or has an income tax liability that is less than the tax credit, a nonrefundable tax credit will not result in a payment from the federal government.

The percentage of the elective contribution (up to a *contribution* of $2,000 per individual) that is available as a tax credit depends upon the employee’s adjusted gross income and his or her tax filing status. The applicable percentages are as shown in the chart below:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Adjusted Gross Income | | | | | | |
| Joint Return | | Head of Household Return | | All Other Status | | Applicable |
| Over | Not over | Over | Not over | Over | Not over | Percentage |
| $0 | $36,500 | $0 | $27,375 | $0 | $18,250 | 50% |
| $36,500 | $39,500 | $27,375 | $29,625 | $18,250 | $19,750 | 20% |
| $39,500 | $61,000 | $29,625 | $45,750 | $19,750 | $30,500 | 10% |
| $61,000 |  | $45,750 |  | $30,500 |  | 0% |

## Distributions

Distributions from a SIMPLE IRA are fully taxable as ordinary income in the year distributed. SIMPLE IRA distributions, not unlike distributions from other tax-favored retirement plans, are intended by Congress to be taken principally for retirement purposes. For that reason, premature distributions—generally those taken before the employee attains age 59½—are also subject to a premature distribution tax penalty, unless a specific exception applies.

### Premature Distributions

However, the tax penalty resulting from a premature distribution from a SIMPLE IRA may be far more taxing than a premature distribution from other tax-favored plans. In general, premature distributions from a SIMPLE IRA are subject to a 10 percent penalty tax on the amount of the premature distribution includible in income. (In most cases, the entire distribution is includible in income.) A premature distribution from a SIMPLE IRA within the first 2 years of employee participation will subject the recipient to a premature distribution tax penalty of 25 percent.

#### Exceptions to Premature Distribution Tax Penalty

There are certain premature distributions to which the 10 percent (or 25 percent) penalty tax doesn’t apply, despite being made prior to the employee’s age 59½. Those distributions include distributions:

* Made at the employee’s death;
* Attributable to the employee’s disability;
* Made for medical care to the extent allowable as a medical expense deduction;
* Made for the payment of health insurance premiums by unemployed individuals;
* Made to pay qualified higher education expenses for the employee, his or her spouse, child or grandchild;
* Considered “first-time homebuyer distributions” up to a lifetime maximum of $10,000; or
* That are part of a series of substantially equal periodic payments made for the life of the employee or the joint lives of the employee and his or her beneficiary

### Required Minimum Distributions

The Internal Revenue Code requires that minimum distributions from a SIMPLE IRA begin no later than the employee’s age 70½, even if the individual is continuing employment. The law permits the employee to delay taking these required minimum distributions until April 1st of the year following the year in which he or she turns age 70½. This is known as the “required beginning date.” By waiting until this required beginning date to take the initial minimum required distribution, the employee must then take a second distribution by December 31st of that same year. As a result, two taxable distributions will occur during the same year, with consequently greater tax liability.

The rules governing required minimum distributions (RMDs) from SIMPLE IRAs are the same rules that apply to traditional IRAs, rather than the rules that apply to qualified retirement plans. As a result, an employee must begin to take at least minimum distributions when he or she reaches age 70 ½ and may not defer taking RMDs until a later retirement date.

In general, the minimum required distribution is equal to the value of the SIMPLE IRA divided by the employee’s remaining life expectancy. In fact, the federal government has made the determination of remaining life expectancy easy by publishing a Uniform Lifetime Table that governs most lifetime required distributions by prescribing distribution periods depending on the age of the individual.

A failure to follow the RMD rules prescribed by the government results in the imposition of additional taxes. The penalty for a failure to take a distribution at least equal to the RMD is 50 percent of the insufficiency. So, if the employee was required to take a minimum distribution of $15,000 and only took $5,000, the failure to take the other $10,000 would result in a tax of $5,000.

The Uniform Lifetime Table governing RMDs is as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Uniform Lifetime Table | | | | | | |
| Age of Employee | Distribution Period | Age of Employee | Distribution Period | | Age of Employee | Distribution Period |
| 70 | 27.4 | 86 | | 14.1 | 101 | 5.9 |
| 71 | 26.5 | 87 | | 13.4 | 102 | 5.5 |
| 72 | 25.6 | 88 | | 12.7 | 103 | 5.2 |
| 73 | 24.7 | 89 | | 12.0 | 104 | 4.9 |
| 74 | 23.8 | 90 | | 11.4 | 105 | 4.5 |
| 75 | 22.9 | 91 | | 10.8 | 106 | 4.2 |
| 76 | 22.0 | 92 | | 10.2 | 107 | 3.9 |
| 77 | 21.2 | 93 | | 9.6 | 108 | 3.7 |
| 78 | 20.3 | 94 | | 9.1 | 109 | 3.4 |
| 79 | 19.5 | 95 | | 8.6 | 110 | 3.1 |
| 80 | 18.7 | 96 | | 8.1 | 111 | 2.9 |
| 81 | 17.9 | 97 | | 7.6 | 112 | 2.6 |
| 82 | 17.1 | 98 | | 7.1 | 113 | 2.4 |
| 83 | 16.3 | 99 | | 6.7 | 114 | 2.1 |
| 84 | 15.5 | 100 | | 6.3 | 115 | 1.9 |
| 85 | 14.8 |  | |  |  |  |

## Rollovers

By following the rules that are set out in the Code and Regulations, an individual can roll over an *eligible rollover distribution* from a SIMPLE IRA and continue to avoid paying current income taxes on the amount rolled over until subsequently distributed. Not every distribution, however, qualifies as an *eligible rollover distribution*.

As we discussed in our earlier examination of traditional IRAs, an eligible rollover distribution is any distribution made to an employee of the funds to his or her credit in a qualified trust EXCEPT for a distribution that is:

* Part of a series of substantially equal payments made over the employee’s life expectancy;
* Made for a specified period of 10 years or more;
* A required minimum distribution; or
* A hardship distribution.

### Direct and Indirect Rollovers

Most distributions from a SIMPLE IRA may be rolled over, provided they are eligible. There are two types of rollovers:

* Trustee to participant to trustee; and
* Trustee to trustee.

A trustee can make the rollover directly to another trustee—for example, a SIMPLE IRA trustee can send the funds directly to a traditional IRA trustee or to the trustee of another SIMPLE IRA—or it can pay the funds to the individual. Unlike a distribution from a qualified plan paid to the employee that is subsequently rolled over, no mandatory withholding applies to a SIMPLE IRA distribution.

### Rollover Recipient Plan

The permitted recipient of a SIMPLE IRA rollover depends on whether or not the rollover is being made during the first 2 years of the employee’s participation.

* If the SIMPLE IRA rollover is being made during the first 2 years of the employee’s participation, the rollover may be made only to another SIMPLE IRA.
* If the SIMPLE IRA rollover is being made after the employee has participated in the plan for at least 2 years, the rollover may be made to either another SIMPLE IRA or to a traditional IRA.

In order to avoid a taxable distribution, the rollover must be completed within 60 days of distribution.

## Summary

SIMPLE plans may be established by small employers with no more than 100 employees earning $5,000 or more. These plans provide the important retirement and tax benefits normally found only in qualified retirement plans but without the more costly setup and administrative charges characteristic of these plans. SIMPLE IRAs are funded by both elective contributions authorized by the employee’s salary reduction agreement and mandatory employer contributions, which may involve matching contributions or nonelective, i.e. non-matching, contributions. Contributions are made before taxes and enjoy tax deferral of growth.

Distributions from a SIMPLE IRA are taxable as ordinary income in the year received. Distributions received before the employee’s age 59½ are subject to a premature distribution tax penalty unless a specific exception applies. Although the premature distribution tax penalty that applies after the employee has been a plan participant for 2 years is 10 percent, the premature distribution tax penalty that applies before the two-year participation period has been completed is 25 percent of the amount of the distribution includible in income.

## Review Quiz #8

1. Howard Johnson, age 35, received a $5,000 distribution from his employer’s SIMPLE IRA in which he had participated for 1 year. During that year he made elective contributions of $2,000. What is the amount of his premature distribution tax penalty assuming no specific exception to the penalty applies?

1. $300
2. $500
3. $700
4. $1,250

2. Shirley, age 42, is employed by an employer who maintains a SIMPLE IRA. She participates in the plan and makes regular elective contributions. She also works part-time as a counselor for a local mental health clinic and participates in its 401(k) plan. In 2015 she made elective deferrals to the 401(k) plan totaling $12,500. What is the maximum amount she can contribute as an elective contribution to her employer’s SIMPLE IRA plan in 2015?

1. $12,500
2. $5,500
3. $18,000
4. $0

3. Henry, age 55, is a participant in his employer’s SIMPLE IRA plan. If he earns $100,000 in 2015, what is the maximum amount he may defer under the plan?

1. $18,000
2. $24,000
3. $12,500
4. $15,500

# Glossary

|  |  |
| --- | --- |
| **Active participant** | An active participant for traditional IRA purposes is an individual that participates in his or her employer’s retirement plan. An employer-sponsored retirement plan includes a pension plan, profit sharing plan, 401(k) plan, 403(b) tax sheltered annuity plan, SEP or SIMPLE. |
| **Coverdell Education Savings Account (ESA)** | An ESA is defined as a trust or custodial account designed to enable the individual to save education funds on a tax-deferred basis and make tax-free withdrawals to pay for qualified education expenses. The amount that an individual can put into an ESA each year for any qualified beneficiary is $2,000. |
| **Custodial account** | A custodial account is an account managed by someone other than the beneficial owner; often the custodian is a professional. IRA funds contributed to a custodial account may be placed in a broad range of investments, including mutual funds, stocks, bonds, savings accounts, CDs and certain gold and silver coins. |
| **Earned income** | The IRA legislation defines earned income as salary, bonus, fees, commissions, tips and alimony. |
| **EGTRRA** | EGTRRA is the Economic Growth and Tax Relief Reconciliation Act of 2001, legislation that has a significant impact on IRA and other contribution limits. |
| **Elective contributions** | Employee elective contributions to a SIMPLE IRA are made under a qualified salary reduction arrangement. A qualified salary reduction arrangement is a written arrangement of an eligible employer under which employees that are eligible to participate may elect to receive payments in cash or contribute them to a SIMPLE IRA. |
| **Eligible educational institution** | The definition of “eligible educational institution” when used in connection with a Coverdell ESA is remarkably broad and covers virtually all accredited public, nonprofit and proprietary educational institutions. An eligible educational institution for purposes of a Coverdell ESA is any college, university, vocational school or other elementary, secondary or postsecondary institution. |

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| **Eligible rollover distribution** | An eligible rollover distribution is any distribution made to an employee of the funds to his or her credit in a qualified trust EXCEPT for a distribution that is:   * part of a series of substantially equal payments made over the employee’s life expectancy * made for a specified period of 10 years or more * a required minimum distribution or * a hardship distribution |
| **FIFO tax treatment (Roth IRAs)** | Under FIFO tax treatment, all contributions are deemed to be distributed *before any earnings are distributed*. Since contributions to a Roth IRA are made with after-tax dollars, they are withdrawn tax free, even though earnings withdrawn in a distribution that is not a “qualified distribution” would be subject to income tax and, possibly, a premature distribution tax penalty. As a result of this favorable tax treatment, a Roth IRA owner can withdraw all of his or her contributions from the account without incurring any income tax liability—and leave all of the earnings in the account continuing to enjoy tax deferral. |
| **Hardship exception to 60-day rollover rule** | The Secretary of the Treasury may waive the 60-day rollover rule where its enforcement would be against equity or good conscience. |
| **IRA catch-up contributions** | In addition to regular IRA contributions, individuals who have attained age 50 before the close of the taxable year for which the IRA contribution is made may make additional contributions, known as “catch-up” contributions. |
| **IRA funding vehicle** | An IRA owner can opt for funding his or her account with an annuity or may use a trust or custodial account through which other products can be purchased. The trust or custodial account must be one that is established to provide benefits for the IRA owner and his or her beneficiaries. These permitted funding approaches apply to both traditional and Roth IRAs. |
| **Mandatory distribution tax withholding** | Any distribution to a participant from a qualified plan, §457 governmental plan or §403(b) tax-sheltered annuity—even if that distribution will be rolled over to another plan—requires that the trustee of the distributing plan withhold 20 percent of the distribution for taxes. Mandatory withholding does not apply to IRA distributions. |

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| **Matching contributions** | If the employer elects to make matching SIMPLE contributions in any year, rather than nonelective contributions, the employer need make contributions *only* for those employees making elective contributions. The matching contributions must be at least equal to the lesser of:   * The amount of the employee’s salary reduction, or * The applicable percentage of compensation for the year |
| **Minimum required distributions** | The Internal Revenue Code requires that minimum distributions from a traditional IRA begin no later than the owner’s age 70½ |
| **Modified Adjusted Gross Income (MAGI)** | Modified adjusted gross income, when used in reference to a Coverdell Education Savings Account, is the individual’s adjusted gross income modified to add back the excluded income derived from certain foreign sources or United States possessions. |
| **Nonelective contributions** | In lieu of matching contributions, an employer may elect to make mandatory contributions under the nonelective contribution formula to a SIMPLE. If the employer makes such an election, it must make a contribution for every eligible employee, *whether or not the employee made an elective contribution*. The employer is required to make a contribution equal to 2 percent of the employee’s compensation. |
| **Premature distribution tax penalty** | In order to ensure that traditional IRAs are used for the purpose they were designed—specifically to accumulate retirement savings—Congress imposed a limitation on their liquidity by specifying a penalty for premature distributions. Usually, in order to avoid a premature withdrawal penalty, the individual must be at least age 59 1/2 before receiving a distribution from a traditional IRA. |
| **Prohibited IRA funding vehicles** | The savings and investment products that are specifically prohibited as IRA funding vehicles are:   * Life insurance, and * Collectibles, such as antiques, artwork, etc. |
| **Qualified distribution from Roth IRA** | A qualified distribution from a Roth IRA is one that is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA and:   * The individual is age 59½ or older; * The distribution is a qualified first-time homebuyer distribution; * The individual is disabled; or * The distribution is made to a beneficiary on or after the individual’s death. |

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| **Qualified education expenses** | The expenses that are considered qualified education expenses for purposes of the Coverdell ESA include higher education expenses and elementary and secondary education expenses. Higher education expenses include tuition, fees, books, supplies, equipment and room and board. Elementary and secondary education expenses include tuition, fees, academic tutoring, special needs services, books, supplies, uniforms, transportation and other supplementary items and services. In addition, qualified education expenses include amounts contributed to a qualified tuition program. |
| **Required beginning date** | The Internal Revenue Code permits the individual to delay taking required minimum distributions from a traditional IRA until April 1st of the year following the year in which he or she turns age 70½. This is known as the “required beginning date.” |
| **Rollover** | A rollover is the transfer of a distribution from certain specified tax-advantaged plans that follows the rules set out in the Internal Revenue Code and Regulations and which enables the individual to maintain the former plan’s tax advantages with respect to the amount transferred. |
| **Roth IRA** | A Roth IRA is a personal retirement savings plan, funded by an annuity or trust/custodial account, which provides income tax deferral and may provide tax-free distribution of earnings. Eligibility for a Roth IRA is limited to individuals, regardless of age or qualified plan participation, provided they don’t exceed certain adjusted gross income limits. |
| **Saver’s credit** | The saver’s tax credit is a *nonrefundable* credit that is designed to encourage certain lower-income individuals to contribute to an IRA and is limited to the applicable percentage of traditional or Roth IRA contributions up to $2,000. |
| **Savings Incentive Match Plan for Employees (SIMPLE)** | A SIMPLE IRA plan is a simplified, tax-favored retirement plan for small employers that provides for elective contributions by employees and meets certain vesting, participation and administrative requirements. |
| **SIMPLE IRA premature distribution** | A premature distribution from a SIMPLE IRA within the first 2 years of employee participation will subject the recipient to a premature distribution tax penalty of 25 percent. Premature distributions after the first 2 years of employee participation are subject to the customary 10 percent. |
| **Simplified employee pension (SEP)** | A SEP is an employer’s agreement to contribute to traditional IRAs that are maintained by employees. The plan can be adopted by an employer by completing a fairly simple IRS form. A SEP allows for higher contribution levels than traditional or Roth IRAs, has fewer restrictions than qualified retirement plans and, unlike SIMPLEs, there is no limit on the number of employees in the plan. Employees are immediately 100 percent vested in their accounts. |

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| --- | --- |
| **Small employer (SIMPLEs)** | In the context of SIMPLE plans, a “small employer” is one with 100 or fewer employees earning at least $5,000 annually. |
| **Special needs beneficiary (ESA)** | Although a final definition of a special needs beneficiary has not yet been provided, a special needs beneficiary—as that term is used with respect to a Coverdell ESA—is expected to include individuals who require additional time to complete their education. A “special needs student” is a student whose physical, mental or emotional limitations require special accommodations to enable the student to successfully pursue higher education. |
| **Spousal IRA** | A spousal IRA is an individual retirement plan designed to provide retirement benefits for an uncompensated spouse. Although the participant in a spousal IRA is not required to meet the earned income requirement for contribution to an IRA, the spousal IRA is available only if the participant is married and filing federal income tax on a joint basis. A spousal IRA, if established, must be a separate account and not commingled with the working spouse’s IRA. |
| **Tax deferral** | Tax deferral is a favorable tax treatment under which an account’s earnings are not subject to income taxation until distributed. |
| **Traditional IRA** | A traditional IRA is a personal retirement savings plan, funded by an annuity or a trust that meets certain requirements and may permit tax-deductible contributions and tax-deferral of earnings. |
| **Trustee-to-trustee rollover** | A trustee-to-trustee rollover is a transfer of funds made directly from the trustee of the existing plan to the trustee of the new plan. By using a trustee-to-trustee rollover of the funds from either a qualified plan, §457 governmental plan or §403(b) tax-sheltered annuity, the participant can avoid the mandatory 20 percent withholding by the transferring trustee. |
| **Uniform Lifetime Table** | The Uniform Lifetime Table, published by the federal government, governs most lifetime required distributions by prescribing distribution periods depending on the age of the individual. |

## Answers to Review Quizzes

### Review Quiz #1

Question 1 Feedback

1. Your answer is correct. Although the participant in a spousal IRA is not required to meet the earned income requirement for contribution to an IRA, a spousal IRA is available only if the participant is married and filing federal income tax on a joint basis. Because Joan files a separate federal income tax return, she is not eligible for a spousal IRA.
2. Your answer is incorrect. The $2,000 IRA maximum contribution limit remained in force for many years but was increased in steps by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and is currently $5,500. However, although your answer is incorrect, it was not incorrect because of the EGTRRA increases. Please try again.
3. Your answer is incorrect. Although you correctly identified the maximum regular IRA contribution amount that might normally be allocated to Joan’s spousal IRA, it does not apply in this case. Please try again.
4. Your answer is incorrect. Your answer choice of $6,500 as the maximum regular IRA contribution is the amount that could normally be allocated to Joan’s spousal IRA if she were at least age 50 in the year for which the contribution is made. However, the issue here is not Joan’s age. Please try again.

Question 2 Feedback

1. Your answer is incorrect. Bill’s adjusted gross income of $200,000 in 2015 neither prohibits a traditional IRA contribution nor—given the facts of the question—affects his ability to take a tax deduction for the contribution. Please try again.
2. Your answer is incorrect. It reflects the limits and rules applicable to IRA contributions in effect prior to the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Please try again.
3. Your answer is incorrect. Although Bill would certainly be able to contribute $5,500 to a regular traditional IRA in 2015 and deduct that amount, your answer does not account for Bill’s age. Please try again.
4. Your answer is correct. Bill may make and deduct a traditional IRA contribution in 2015 that is neither eliminated nor reduced by his relatively high adjusted gross income. Because he is age 50 or older, the maximum contribution allowable in 2015 includes both a *regular* IRA contribution of $5,500 and a *catch-up* contribution of an additional $1,000. Since he is not an active participant in an employer-sponsored qualified plan, his entire traditional IRA contribution is tax-deductible.

Question 3 Feedback

1. Your answer is incorrect. In order for Shirley, an active participant in her employer’s qualified plan, to be able to deduct her entire traditional IRA contribution, her adjusted gross income would need to be no more than $61,000 in 2015. Please try again.
2. Your answer is correct. Although Shirley may make a full $5,500 traditional IRA contribution in 2015, her status as an active participant in an employer-sponsored qualified retirement plan coupled with her adjusted gross income will result in a reduction in the amount she can deduct from her gross income. The reduction in the amount of her traditional IRA contribution that she can deduct is determined by using the following formula:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction of Deduction | = | Maximum deduction | x | AGI – applicable dollar amount $10,000 |

Shirley’s maximum IRA contribution in 2015 is $5,500. Since her AGI is $68,000 and the 2015 applicable dollar amount is $61,000, we can see the reduction in her deduction is $3,850 by substituting the appropriate numbers in the formula as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $3,850 | = | $5,500 | x | $68,000 – $61,000 $10,000 |

Since her deduction is reduced by $3,850, the amount she may deduct is $1,650. ($5,500 - $3,850 = $1,650)

1. Your answer is incorrect. The answer you chose, i.e. $3,850, is the amount of the *reduction* in Shirley’s deduction, rather than the deduction itself. Please try again.
2. Your answer is incorrect. Although Shirley’s deduction is reduced because she is an active participant in her employer’s qualified retirement plan and has an adjusted gross income of more than $61,000, her deduction would not be eliminated entirely unless her AGI was $71,000 or more. Please try again.

### Review Quiz #2

Question 1 Feedback

1. Your answer is correct. Required minimum distributions (RMD) are not eligible for rollover. Accordingly, no part of Helen’s RMD may be rolled over. In addition to required minimum distributions, certain other distributions are ineligible for rollover, including hardship distributions and distributions that are made for a specified period of 10 years or more or are part of a series of substantially equal payments made over the individual’s life expectancy.
2. Your answer is incorrect. Not all traditional IRA distributions are eligible for rollover. Please try again.
3. Your answer is incorrect. Mandatory 20% withholding does not apply to distributions received from a traditional IRA. So, assuming Helen were permitted to rollover her traditional IRA distribution, the entire amount could be rolled over. Please try again.
4. Your answer is incorrect. Your answer choice suggests that only an amount equal to the funds normally retained by a qualified plan trustee pursuant to mandatory withholding would be eligible for rollover. However, mandatory 20% withholding does not apply to traditional IRA distributions made directly to the account owner. Furthermore, certain distributions are not eligible for rollover. Please try again.

Question 2 Feedback

1. Your answer is incorrect. The employer’s qualified plan trustee is required to withhold 20% of any distribution made from a qualified plan to a plan participant, even if the amount distributed is rolled over by the participant. The amount withheld by the trustee is deemed to be distributed to the participant and is subject to income taxation. Please try again.
2. Your answer is incorrect. Any distribution to a participant from a qualified plan, §457 governmental plan or §403(b) tax-sheltered annuity—even if that distribution will be rolled over to another plan—requires that the trustee of the distributing plan withhold 20 percent of the distribution for taxes. The amount withheld is itself considered a distribution and subject to taxation and premature withdrawal penalties. Your answer correctly identifies the amount of the regular income tax liability, but does not address any premature distribution tax penalty. Please try again.
3. Your answer is correct. The qualified plan trustee is required to withhold 20% of any distribution made to Peter. Since the entire $200,000 balance of his qualified plan account was distributed, the trustee must withhold $40,000 to offset Peter’s tax liability. Because the amount withheld by the trustee is deemed distributed to Peter for tax purposes—even if the other $160,000 is rolled over—that withheld amount is subject to normal income taxation and, because Peter is not at least age 59½, to a premature distribution tax penalty of 10% of the amount includible in income. Thus, the income tax on the $40,000 in Peter’s tax bracket is $10,000. In addition, because the entire $40,000 is includible in Peter’s income, a penalty tax of $4,000 is payable. Accordingly, Peter’s partially rolled over distribution results in a total income tax liability of $14,000.
4. Your answer is incorrect. You have correctly determined that the amount of Peter’s vested account value that is withheld by the plan trustee is subject to a 10% premature distribution tax penalty. However, the amount withheld is also considered a distribution to Peter for tax purposes; that tax liability must also be taken into consideration. Please try again.

Question 3 Feedback

1. Your answer is incorrect. For distributions after December 31, 2001, after-tax contributions made to a qualified plan can be rolled over from the qualified plan to a traditional IRA. Please try again.
2. Your answer is correct. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) permitted a separating qualified plan participant to roll over after-tax contributions made to a qualified plan to a traditional IRA. Since before-tax contributions and gain could already be rolled over, the entire $200,000 is eligible for rollover to a traditional IRA.
3. Your answer is incorrect. Qualified plan amounts in addition to before-tax contributions may be rolled over to a traditional IRA. Please try again.
4. Your answer is incorrect. Although EGTRRA authorized the rollover of after-tax qualified plan contributions to a traditional IRA, other monies contained in Edna’s qualified plan account may also be rolled over. Please try again.

### Review Quiz #3

Question 1 Feedback

1. Your answer is incorrect. The premature distribution penalty is equal to 10 percent of the amount of the distribution that is includible in the individual’s gross income. Since part of the distribution is not includible in Ellen’s income, that non-includible part of the distribution is not subject to the tax penalty. Please try again.
2. Your answer is incorrect. You have identified part of the distribution that is includible in Ellen’s income—the total of her deductible contributions—and applied the appropriate 10% tax penalty to it. However, more than just the amount equal to her deductible contributions are includible in her income and that also needs to be considered. Please try again.
3. Your answer is correct. Of Ellen’s total distribution of $500,000, only the amount of her non-deductible contributions—$50,000, in this case—would not be includible in her income. The remaining $450,000, comprised of pre-tax contributions and earnings, is includible in her gross income and subject to both regular income taxation and a tax penalty of $45,000. ($450,000 *x* 10% = $45,000)
4. Your answer is incorrect. You have identified the earnings Ellen’s IRA account has accrued which, of course, are subject to both income taxation and a premature distribution tax penalty. However, another piece of the distribution is also includible in Ellen’s income. Please try again.

Question 2 Feedback

1. Your answer is incorrect. After-tax contributions to a traditional IRA are received pro-rata in any distribution. Accordingly, some portion of Carol’s $10,000 distribution from her traditional IRA would be received tax-free and the balance would be taxable. Please try again.
2. Your answer is correct. Distributions of unrecovered after-tax contributions made to a traditional IRA are received tax-free as a return of basis, and the remainder of the distribution is taxable. The formula used to determine how much of any distribution should be considered a tax-free return of after-tax contributions is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Unrecovered non-deductible contributions  Total IRA balance (at year end of the year of the distribution) + Distribution amount | x | Distribution amount | = | Tax-free portion of distribution |

By substituting the appropriate amounts in the formula, we can see that the tax-free part of Carol’s $10,000 distribution is $1,000, as shown below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $20,000  $190,000 + $10,000 | x | $10,000 | = | $1,000 |

1. Your answer is incorrect. Distributions of unrecovered after-tax contributions to a traditional IRA are received pro-rata. The determination of the portion of such distribution that is tax-free as a return of basis requires that the tax adviser compare the unrecovered after-tax contributions to an amount equal to the sum of the account balance at the end of the year in which the distribution is made and the amount of the distribution. Please try again.
2. Your answer is incorrect. Distributions of unrecovered after-tax contributions to a traditional IRA are received pro-rata. As a result of that treatment, a part of each distribution is taxable as income and a part is tax-free as a recovery of basis. Please try again.

Question 3 Feedback

1. Your answer is correct. No special spousal election is permitted when an IRA owner’s death occurs after the required beginning date. If a traditional IRA owner's death occurs on or after the required beginning date but before the entire IRA interest has been distributed, the balance of the IRA—regardless of the beneficiary’s relationship to the deceased owner—must be distributed at least as quickly as under the method of distribution in effect at the time of the traditional IRA owner’s death.
2. Your answer is incorrect. The special spousal election to treat the IRA as his or her own is available only if death occurs before the required beginning date and the spouse is the sole beneficiary who possesses an unlimited right to make withdrawals. In this case, since Allen’s death occurred after the required beginning date, this option is not available. Please try again.
3. Your answer is incorrect. The option to take the IRA balance in a lump-sum at the conclusion of a five-year period is available only if the owner died before the required beginning date. It would not be available in this case. Please try again.
4. Your answer is incorrect. The beneficiary’s ability to take the IRA balance over her life expectancy is available only when the traditional IRA owner’s death occurs before the required beginning date. Please try again.

### Review Quiz #4

Question 1 Feedback

1. Your answer is incorrect. Based on Allen’s filing status and adjusted gross income, his eligibility to make a Roth IRA contribution in 2015 does not cease unless his AGI is $193,000 or greater. Please try again.
2. Your answer is correct. The maximum contribution that may be made to a Roth IRA is reduced for a married taxpayer filing a joint federal income tax form, based on the individual’s adjusted gross income, according to the following formula:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Contribution reduction | = | AGI – applicable dollar amount  $10,000 | X | Maximum contribution |

By substituting the appropriate values in the formula, we can see that Allen’s maximum contribution—normally limited to $5,500 in 2015—is reduced by $3,300. Thus, he may make a maximum Roth IRA contribution of $2,200. ($5,500 - $3,300 = $2,200) The formula for the reduction is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $3,300 | = | $189,000 – $183,000  $10,000 | X | $5,500 |

1. Your answer is incorrect. When determining the maximum permissible Roth IRA contribution, it is important to remember that the formula gives you the amount of the *reduction* in the maximum contribution. The result you obtain by using the formula is not the allowable contribution. Please try again.
2. Your answer is incorrect. Because Allen’s AGI exceeds the applicable dollar amount, his maximum Roth IRA contribution is reduced. Please try again.

Question 2 Feedback

1. Your answer is correct. Since non-qualified distributions are subject to FIFO tax treatment, her entire cost basis is recovered tax-free before any taxable gain is deemed distributed. Because her cost basis is $30,000, all of her $25,000 withdrawal is considered a tax-free recovery of basis.
2. Your answer is incorrect. Audrey’s non-qualified distribution will leave her with a continued cost basis of $5,000. That amount, however, is not taxable. Please try again.
3. Your answer is incorrect. The answer you selected, i.e. $15,000, would be correct if Roth IRAs were subject to LIFO tax treatment since the account has a gain of $15,000. However, Roth IRAs are given more favorable FIFO tax treatment. Please try again.
4. Your answer is incorrect. Since the gain on the Roth IRA is only $15,000, Audrey’s $25,000 withdrawal could not exceed $15,000 even if it were subject to LIFO tax treatment. However, Roth IRA non-qualified distributions receive more favorable FIFO tax treatment. Please try again.

Question 3 Feedback

1. Your answer is incorrect. Although Henry’s Roth IRA has been in effect for more than the required five-year holding period, the total distribution from the account is not a qualified distribution. Accordingly, the gain must be recognized. Please try again.
2. Your answer is incorrect. Although you have correctly identified the tax penalty that would be imposed on Henry’s non-qualified distribution from his Roth IRA, you also need to consider the regular income tax liability. Please try again.
3. Your answer is incorrect. You have determined part of Henry’s income tax liability for his non-qualified distribution. However, an additional tax penalty will be imposed. Please try again.
4. Your answer is correct. Since Henry’s distribution from the Roth IRA is a non-qualified distribution, the $35,000 gain on the account must be recognized for tax purposes. In Henry’s 25% income tax bracket, his regular tax liability resulting from the distribution is $8,750. ($35,000 *x* 25% = $8,750) However, in addition to that regular tax liability, an income tax penalty of $3,500 will be imposed because the distribution occurred before his age 59½ and no exception to the premature distribution tax penalty applied. Accordingly, Henry’s total income tax liability resulting from his non-qualified Roth IRA distribution is $12,250.

### Review Quiz #5

Question 1 Feedback

1. Your answer is incorrect. Gold coins are one of the various investments to which IRA assets may be allocated through a trust or custodial account. Please try again.
2. Your answer is correct. Life insurance—as well as collectibles, such as antiques and artwork—is specifically prohibited as an IRA funding vehicle.
3. Your answer is incorrect. Stocks, whether common or preferred, are permitted IRA funding vehicles. Please try again.
4. Your answer is incorrect. An IRA owner may invest some or all of his or her IRA assets in traditional savings vehicles, such as a passbook savings account or a certificate of deposit. Please try again.

Question 2 Feedback

1. Your answer is incorrect. Capital gains tax rates are not applicable to transactions involving qualified plans or other, similar tax-advantaged retirement plans. Please try again.
2. Your answer is incorrect. In the event an annuity permitted a contract owner to borrow under the contract, no surrender charges are imposed. Please try again.
3. Your answer is correct. Pledging an individual retirement annuity as collateral for a loan could cause the plan to become disqualified. When disqualified, the plan funds are immediately subject to income taxation and, if the IRA owner is younger than age 59½, a penalty equal to 10 percent of the amount includible in the individual’s income may be imposed for premature distribution.
4. Your answer is incorrect. Although loans may be made under certain qualified plans if the plan document provides for them, such a provision does not apply to an IRA. Please try again.

Question 3 Feedback

1. Your answer is incorrect. Tax-deductibility of traditional individual retirement account contributions—whether used for allocation to a custodial/trust account or for purchase of an annuity—is the result of the IRA, rather than being due to the particular investment vehicle. Accordingly, Pat’s desire to have tax-deductible contributions should not affect her choice of an appropriate investment to which to allocate her IRA contributions. Please try again.
2. Your answer is incorrect. Tax-deferral is a characteristic of all IRAs, and is not dependent on the investment to which IRA assets are allocated. Please try again.
3. Your answer is incorrect. Traditional IRAs do not enjoy FIFO tax treatment, although Roth IRAs do. Despite that, however, the decision to fund a traditional IRA with an annuity should not hinge on the tax treatment of withdrawals. Please try again.
4. Your answer is correct. The NASD (now FINRA) has published guidelines concerning the use of variable annuities to fund tax-qualified plans, including IRAs, which state that an annuity should be recommended as an IRA funding vehicle only when the individual is seeking the *non-tax benefits* of an annuity, such as its ability to provide a life income or its death benefits.

### Review Quiz #6

Question 1 Feedback

1. Your answer is incorrect. Although Helen’s modified adjusted gross income exceeds the applicable amount, her eligibility to make an ESA contribution in 2015 is not eliminated. Please try again.
2. Your answer is correct. While Helen’s modified adjusted gross income is greater than the applicable amount, the ESA contribution she may make is not eliminated. Instead, it is limited in accordance with a formula that reduces the allowable contribution over a $30,000 MAGI range from $190,000 to $220,000. The formula for calculating the reduction from the maximum ESA contribution for higher-income joint filers is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| MAGI - $190,000  $30,000 | x | Maximum Permitted Contribution | = | Reduction in Contribution |

Since Helen’s 2015 MAGI is $205,000, her maximum ESA contribution is reduced to $1,000 as shown in the following formula:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $205,000 - $190,000  $30,000 | x | $2,000 | = | $1,000 |

1. Your answer is incorrect. Although Helen could normally make a $2,000 ESA contribution for her granddaughter, her modified adjusted gross income affects the amount of her permitted contribution. Please try again.
2. Your answer is incorrect. Although a $5,500 contribution could be made to an individual retirement account, that limit does not apply to Coverdell Education Savings Accounts. Please try again.

Question 2 Feedback

1. Your answer is incorrect. Barbara’s receipt of an American Opportunity Credit will affect her qualified education expenses and, as a result, the amount of tax-free distribution she can receive from her Coverdell ESA. Please try again.
2. Your answer is incorrect. Although Barbara’s receipt of an American Opportunity Credit reduces her qualified education expenses and, as a result, the maximum amount of tax-free distribution from her Coverdell ESA, the credit does not eliminate the tax-free distribution. Please try again.
3. Your answer is correct. Barbara’s receipt of a $2,500 American Opportunity Credit reduces her qualified education expenses by $4,000, the amount of qualified education expenses that must be taken into account. Accordingly, her qualified education expenses are reduced to $21,000. Since tax-free distributions from an ESA are limited to no more than qualified education expenses, her tax-free distribution is reduced to $21,000.
4. Your answer is incorrect. The American Opportunity Credit is not added to the total of qualified education expenses in order to determine the tax-free ESA distribution. Please try again.

Question 3 Feedback

1. Your answer is correct. Distributions from an ESA may be includible in the recipient’s income if they exceed the designated beneficiary’s qualified education expenses. In such a case, a calculation involving four steps is used to determine the amount of the distribution that is includible in gross income. Determining the includible amount of any excess distribution requires first that the investment in the ESA be subtracted from the total distribution. In Arthur’s case, the $36,000 contributed to the ESA must be subtracted from the $40,000 distribution; the result is $4,000. In the second step, the qualified education expenses must be divided by the distribution. The qualified education expenses, for purposes of the ESA, are $30,000 less the amount of the expenses taken into account for the American Opportunity Credit, or $26,000. By dividing the $26,000 of expenses by the amount of the distribution, a ratio of .65 is determined. ($26,000 ÷ $40,000 = .65) In the third step, the ratio is multiplied by the $4,000 result determined in step 1 to yield a tax-free amount of $2,600 that represents a recovery of basis. The final step is to subtract the $2,600 tax-free amount from the amount of the distribution in excess of the total ESA contributions, i.e. $4,000. The resulting amount—$1,400, in this case—is includible in income.
2. Your answer is incorrect. A portion of an ESA distribution in excess of qualified education expenses may be includible in income if the distribution exceeds the sum of the contributions made to the ESA. The includible portion is based on a ratio calculation. Since Arthur’s distribution exceeds his qualified education expenses and the sum of the ESA contributions, a portion of the excess distribution is includible in income. Please try again.
3. Your answer is incorrect. Although the distribution from the ESA exceeds Arthur’s qualified education expenses by $14,000, the total ESA gain includible in income may be much less. Please try again.
4. Your answer is incorrect. An excess ESA distribution may be includible in the recipient’s income. Although the total distribution exceeds the sum of the ESA contributions by $4,000, only a portion of that excess distribution is includible in income. Please try again.

### Review Quiz #7

Question 1 Feedback

1. Your answer is incorrect. In order for Patrick, an active participant in his employer’s SEP IRA, to be able to deduct his entire employee contribution, his adjusted gross income would need to be no more than $98,000 in 2015. Please try again.
2. Your answer is incorrect. The answer you chose, i.e. $4,875, is the amount of the *reduction* in Patrick’s deduction, rather than the deduction itself. Please try again.
3. Your answer is correct. Although Patrick may make an employee contribution of up to $6,500 to his SEP IRA account in 2015, his status as an active participant in his employer’s SEP IRA may limit the amount of his deduction for the employee contribution, depending on his adjusted gross income. The reduction in the amount of his employee contribution that he can deduct is determined by using the following formula:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Reduction of Deduction | = | Maximum deduction | x | AGI – applicable dollar amount $20,000 |

Patrick’s maximum employee contribution to his employer’s SEP IRA in 2015 is $6,500, comprised of both a regular and a catch-up contribution. Since his AGI is $113,000 and the 2015 applicable dollar amount is $98,000, we can see the reduction in his deduction is $4,875 by substituting the appropriate numbers in the formula as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $4,875 | = | $6,500 | x | $113,000 – $98,000 $20,000 |

Since his deduction is reduced by $4,875, the amount he may deduct is $1,625. ($6,500 - $4,875 = $1,625)

1. Your answer is incorrect. Although Patrick’s deduction is reduced because he is an active participant in his employer’s SEP IRA and has an adjusted gross income of more than $96,000, his deduction would not be eliminated entirely unless his AGI was $116,000 or more. Please try again.

Question 2 Feedback

1. Your answer is correct. Harriet’s tax liability is comprised of the liability resulting from her need to recognize the taxable distribution of $25,000 in her 25% tax bracket *plus* the tax penalty of 10% on the includible distribution in excess of the $10,000 first-time homebuyer exception to the premature withdrawal tax penalty. Her tax liability is, therefore, $7,750. ($25,000 *x* 25% = $6,250 *plus* $15,000 *x* 10% = $1,500; $6,250 + $1,500 = $7,750)
2. Your answer is incorrect. Although Harriet receives a $10,000 exception to the premature withdrawal tax penalty as a first-time homebuyer, she must, nonetheless, recognize the entire $25,000 distribution as ordinary income. Please try again.
3. Your answer is incorrect. Harriet receives a $10,000 exception to the premature distribution tax penalty as a first-time homebuyer that was not considered. Please try again.
4. Your answer is incorrect. Although a portion of Harriet’s distribution is exempt from the imposition of a premature distribution tax penalty as a first-time homebuyer, the balance of the distribution is subject to the tax penalty. Furthermore, the entire amount of the distribution is includible in Harriet’s gross income. Please try again.

Question 3 Feedback

1. Your answer is incorrect. A portion of Audrey’s $20,000 SEP IRA distribution is deemed to be comprised of a tax-free recovery of her non-deductible plan contributions. Please try again.
2. Your answer is correct. Since Audrey had made non-deductible contributions to her SEP IRA account that had not yet been recovered, a portion of her distribution is deemed to be comprised of a tax-free recovery of such contributions. The formula for calculating the portion of a SEP distribution that is excludable from income as being attributable to non-deductible contributions is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Unrecovered non-deductible contributions  Total SEP balance + Distribution amount | x | Distribution amount | = | Tax-free portion of distribution |

Since Audrey’s unrecovered non-deductible contributions were $50,000 and her SEP balance at the end of the year was $480,000 we can easily determine the tax-free portion of the distribution and the portion that must be included in income by substituting the appropriate values in the formula.

The result of the substitution is $2,000 as shown below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $50,000  ($480,000 + $20,000) | X | $20,000 | = | $2,000 |

Since $2,000 of the $20,000 distribution is tax-free as a recovery of Audrey’s basis, the balance of $18,000 is includible as ordinary income.

1. Your answer is incorrect. You have made the appropriate calculation to determine the tax-free portion of the distribution rather than the includible portion. Please try again.
2. Your answer is incorrect. Although Audrey’s non-deductible contributions exceed the total amount of her distribution, the non-deductible contributions are recovered on a pro-rata basis rather than all at one time. Please try again.

### Review Quiz #8

Question 1 Feedback

1. Your answer is incorrect. The premature distribution tax penalty applies to all of the distribution that is includible in income. In Howard’s case, the entire amount of his distribution must be included. Additionally, the tax penalty is increased for distributions during the first two years of plan participation. Please try again.
2. Your answer is incorrect. Although the entire distribution is correctly shown as being includible in income, the tax penalty levied on distributions occurring in the first two years of plan participation is increased. Please try again.
3. Your answer is incorrect. The tax penalty for premature distributions from a SIMPLE IRA is based on the entire amount includible in the participant’s income, i.e. $5,000. The amount of the penalty is also affected by the duration of Howard’s plan participation. Please try again.
4. Your answer is correct. The premature distribution tax penalty imposed on Howard’s $5,000 distribution from a SIMPLE IRA would normally be at the rate of 10%, a rate that would result in a $500 tax penalty. However, since Howard’s distribution occurs within the first two years of his plan participation, the tax penalty is 25%, resulting in a penalty of $1,250. ($5,000 *x* 25% = $1,250)

Question 2 Feedback

1. Your answer is incorrect. Elective contributions to a SIMPLE IRA are counted in the overall limit on elective deferrals that may be made by any individual. Since Shirley made an elective deferral of $12,500 to the 401(k) plan, her elective contributions to the SIMPLE IRA are limited to the lesser of the permitted amount of elective contributions to the SIMPLE or the balance of permitted elective deferrals. Please try again.
2. Your answer is correct. Although Shirley would normally have been permitted to make an elective contribution to the SIMPLE IRA of up to $12,500 in 2015, her $12,500 in elective deferrals under the 401(k) plan in which she participates reduces the maximum amount she can contribute to the SIMPLE IRA. That smaller amount is the lesser of $12,500 or the overall elective deferral limit reduced by the elective deferrals she made to the 401(k) plan, i.e. $5,500.
3. Your answer is incorrect. That is the amount of the overall limit on elective deferrals in effect in 2015. The amount of elective contribution that may be made to a SIMPLE IRA is smaller. Please try again.
4. Your answer is incorrect. Although Shirley’s elective deferral of $12,500 to the 401(k) plan in which she participates reduces the amount she can electively contribute to the SIMPLE IRA because of the overall limit on elective deferrals, it does not eliminate her ability to contribute during 2015. Please try again.

Question 3 Feedback

1. Your answer is incorrect. The overall limit on elective deferrals applicable to other than catch-up contributions is $18,000 in 2015. Although this overall limit may affect the amounts deferred by individuals participating in multiple deferral plans, it is not the limit specifically applicable to SIMPLE IRA plans. Please try again.
2. Your answer is incorrect. This is the overall limit on elective deferrals, increased by catch-up contributions applicable in 2015. Although this limit applies to various deferral plans, including 401(k) plans, SEPs, 403(b) plans and Section 457 plans, it does not apply to SIMPLE plans. Please try again.
3. Your answer is incorrect. This is the 2015 limit on regular elective contributions that may be made to a SIMPLE plan. However, it does not reflect the increased limits available to plan participants age 50 or older—participants such as Henry—who choose to make catch-up contributions. Please try again.
4. Your answer is correct. The maximum amount Henry may defer under his employer’s SIMPLE IRA plan in 2015 is the regular limit on SIMPLE elective contributions of $12,500 *plus* catch-up contributions not exceeding $3,000—a total of $15,500.

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Information is also available from the Internal Revenue Service Web site: http://www.irs.gov.

1. Note that the adjusted gross income may change from year to year. [↑](#footnote-ref-1)
2. An apparent contradiction applies with respect to 401(k) and 403(b) plan designated Roth accounts from which RMDs must be taken. [↑](#footnote-ref-2)
3. IRC Section 410(a )(17) caps the annual compensation that can be taken into account when determining contributions and benefits under qualified plans. As noted, in 2015 this limit is $265,000. This limit does not apply to employer- matching contributions to SIMPLE plans; however, it does apply to nonelective employer contributions. [↑](#footnote-ref-3)