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(800) 345-5669
www.EJBfinpress.com

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ABOUT THE AUTHOR

Edward J. Barrett CFP®, ChFC®, CLU, CEBS®, RPA, CRPS®, CRPC®, began his career in the financial and insurance services back in 1978 with IDS Financial Services, becoming a leading financial Advisor and top district sales manager in Boston, Massachusetts. In 1986, Mr. Barrett joined Merrill Lynch in Boston as a Financial Advisor and then becoming the Estate and Business Insurance Planning Specialist working with over 400 Financial Advisors and their clients throughout the New England region assisting in the sale of insurance products.

In 1992, after leaving Merrill Lynch and moving to Florida, Mr. Barrett founded The Barrett Companies Inc. and The Wealth Preservation Planning Associates, a financial and insurance brokerage agency. During the same period, Mr. Barrett also formed Broker Educational Sales & Training Inc., a premier provider of training and continuing education programs to financial and insurance professionals in all 50 states and the District of Columbia.

Mr. Barrett is a highly sought after speaker for financial advisors, insurance professionals, attorneys, CPA’s and general audiences. He has written over 1,000 financial articles for newspapers and magazines and has authored several books.

Mr. Barrett was a qualifying member of the Million Dollar Round Table, Qualifying Member Court of the Table® and Top of the Table® producer. He holds the Certified Financial Planner designation CFP®, Chartered Financial Consultant (ChFC), Chartered Life Underwriter (CLU), Certified Employee Benefit Specialist (CEBS), Retirement Planning Associate (RPA), Chartered Retirement Planning Counselor (CRPC) and the Chartered Retirement Plans Specialist (CRPS) professional designations.

About EJB Financial Press

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CHAPTER 1

HISTORY OF IRAs

Overview

In 1974, Congress enacted (and President Gerald R. Ford signed into law) the Employee Retirement Income Security Act (ERISA) of 1974. The purpose of the Act was to protect and enhance Americans’ retirement security by establishing comprehensive standards for employee benefit plans. The Act also created the Individual Retirement Arrangement, or IRA.

This chapter will examine the background and the dual purpose of the Individual Retirement Arrangement (IRA), as well as the legislative history and current market overview.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Explain the intent and purpose of Congress in developing the IRA;
- Outline the various legislative changes that have affected the IRA since its inception; and
- Present the growth and current market opportunity with IRAs.

Background of IRAs

The Employee Retirement Income Security Act (ERISA) was signed into law in 1974. ERISA established for the first time comprehensive standards to help protect the retirement programs of Americans, and also created the Individual Retirement Arrangement, or IRA.

Dual Purpose of IRAs

To give the new account flexibility in accumulating assets for retirement, Congress designed a dual role for IRAs.

- First, to give individuals not covered by retirement plans at work an opportunity to save for retirement on their own in tax-deferred accounts made available through private financial institutions; and
Secondly, to give retiring workers or individuals changing jobs a means to preserve employer-sponsored retirement plan assets by allowing them to transfer, or rollover, plan balances into IRAs.

Eligible workers under the age of 70 ½ could contribute annually to an IRA the lesser of $1,500 or 15 percent of compensation. Individuals did not pay income taxes on these contributions (after-tax, non-deductible, contributions were not allowed), but rather the contributions and investment earnings were taxed when withdrawn from the IRA.

To facilitate the preservation of retirement savings accrued in the workplace, the original IRA legislation also permitted workers in employer-sponsored retirement plans to transfer, or rollover, plan assets into Traditional IRAs, when retiring or changing jobs. This feature continues to be very important to preserve assets accumulated in employer-sponsored plans for retirement in tax-advantaged specially earmarked accounts (see Chapter 6).

The IRA was immediately popular, with contributions totaling $1.4 billion in 1975, the first year in which the new savings instrument was available.

**Legislative Timeline of IRAs**

Since Congress created the Original, or Traditional IRA (see Chapter 2), Congress has changed eligibility and distribution rules several times and added new types of IRAs.

- **In 1978**, Congress passed *The Revenue Act of 1978* (TRA) which established the Simplified Employee Pension (SEP) IRA—an employer-sponsored IRA (see Chapter 3).
- **In 1981**, Congress passed *The Economic Recovery Tax Act* (ERTA), which included provisions to encourage Americans to save through IRAs. Starting in 1982, the Act raised the annual contributions limit to the lesser of $2,000 or 100 percent of compensation (Note: A total of $2,250 or 100 percent of compensation could be contributed by an individual taxpayer and a non-working spouse outside of the home, and the overall limit no longer had to be divided equally with the spouse, but of course neither individual’s IRA could accept more than the $2,000 limit). Furthermore, it made the IRA “universal” by allowing any individual taxpayer under the age of 70 ½ with earned compensation to make a tax-deductible contribution to an IRA regardless of retirement plan coverage. Thus any individual participating in an employer-sponsored retirement plan was eligible to make a tax-deductible Traditional IRA contribution. During this period when IRA rules were simplified and eligibility was expanded, Traditional IRA contributions rose sharply, averaging $34.4 billion per year from 1982 through 1986.
- **In 1986**, concerned about the performance of the economy, Congress passed the *Tax Reform Act of 1986* (TRA), which eliminated “universal” deductible IRA eligibility. The Act re-established employer-sponsored retirement plan coverage as the basis for eligibility to make tax-deductible contributions to IRA (see
Chapter 2). However, TRA of 1986, for the first time allowed individual taxpayer’s under the age of 70 ½ with earned compensation (income) to make non-deductible (after-tax) contributions (irrespective of retirement plan coverage at work). The result of these new provisions of TRA of 1986 was to drastically reduce deductible contributions and reduce participation among many households who continued to be eligible. In 1987, the first year the new provisions were in effect, the IRS reported that deductible contributions were $1.4 billion down from the $37.8 billion in 1986.

- In 1996, Congress passed the **Small Business Job Protection Act of 1996**, which created the Savings Incentive Match Plan for Employees, or SIMPLE IRA, an account targeted to small businesses (see Chapter 4).
- In 1997, Congress eased restrictions on eligibility in the **Taxpayers Relief Act of 1997**, which became effective on January 1, 1998, by raising the income limits that determine whether an individual taxpayer covered by an employer-sponsored retirement plan is also eligible to make deductible IRA contributions. In addition, Congress allowed spouses not covered by an employer-sponsored retirement plans at work to make tax-deductible contributions irrespective of their spouse’s coverage (see Chapter 2). Despite these measures, deductible contributions in the late 1990s and early 2000s remained well below the high levels reached between 1982 through 1986 period of universality. However, a new IRA was created under the TRA of 1997, known as the Roth IRA—a retirement savings account for after-tax contributions (see Chapter 8).
- In 2001, Congress passed the **Economic Growth Tax Relief and Reconciliation Act of 2001 (EGTRRA)** which increased the amount of contributions as well as allowing a catch-up contribution for those participants age 50 and older. EGTRRA provisions also created the Deemed IRA and the Roth 401(k) (see Chapter 8).
- In 2005, Congress passed the **Tax Increase Prevention Reconciliation Act of 2005**, which made sweeping changes to the Roth IRA (see Chapter 8).
- In 2006, Congress passed the **Pension Protection Act of 2006 (PPA)**, which makes permanent a number of provisions of EGTRRA that were going to sunset.
- In 2008, Congress passed and President George W. Bush signed into law on December 23, 2008, **The Workers, Retiree, and Employer Recovery Act of 2008 (WRERA)**, the law temporarily (2009 only) suspended the requirement for taxpayers’ age 70½ and older (and their beneficiaries) to take annual RMDs from their retirement accounts (see Chapter 6 and 7). The Act also includes some clarification for non-spouse beneficiary’s inherited IRA rollovers (see Chapter 7).
- May 2010, **The Small Business Job Act**, Sections 2111 and 2112 of this new legislation, permits participants in 401(k) 403(b) and governmental 457 plans to make in-plan Roth conversions of their pre-tax employee contributions effective for distributions made after September 27, 2010 (see Chapter 8).
- December 2010, **The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (TRA) of 2010**, The Act contains a provision extending qualified charitable IRA distributions through the 2010 and 2011 tax years (see Chapter 6).
- December 2012, **The American Taxpayers Relief Act (ATRA) of 2012**, provides a new provision expanding the ability for employees to convert traditional
retirements accounts (like 401(k), 403(b) and government sponsored 457(b) plans) into Roth 401(k) accounts (see Chapter 8). And, the Act also extended through 2013, the qualified charitable IRA distributions which was originally enacted by WRERA of 2008 and extended by TRA of 2010 through 2010 and 2011 tax years (see Chapter 6).

- December 2015, The Protecting Americans From Tax Hikes Act (PATH) of 2015, makes permanent the IRA Charitable rollover provision, also known as the Qualified Charitable Distribution (QCD), which has shifted millions of dollars from IRAs into charity, retroactive to January 1, 2015 (see Chapter 6). In addition, the PATH made changes to SIMPLE IRA rollover rules (see Chapter 4) and expanded the provision to cover other categories of public safety officers (see Chapter 6).

Retirement Market Overview

According to the Investment Company Institute (ICI) report, “The U.S. Retirement Market, 4th Quarter 2016,” total U.S. retirement assets were $25.3 trillion as of March 22, 2017 ICI Research & Statistics (see Figure 1.1). Retirement assets accounted for 31 percent of all household financial assets in the United States at the end of the fourth quarter of 2016. The largest components of retirement assets were IRAs totaling $7.9 trillion at the end of the fourth quarter of 2016, an increase of 1.8 percent from the end of the fourth quarter of 2015. Defined contribution (DC) plan assets rose 2.1 percent in the fourth quarter of 2016 to $7.0 trillion. Government defined benefit (DB) plans—including federal, state, and local government plans—held $5.5 trillion in assets as of the end of December, a 0.3 percent increase from the end of March. Private-sector DB plans held $2.9 trillion in assets, and annuity reserves outside of retirement accounts accounted for another $2.0 trillion.

Figure 1.1

U.S. Total Retirement Market
$25.3 Trillion (4th Quarter, 2016)

Source: ICI Research & Statistics, March 2017
https://www.ici.org/research/stats/retirement/ret_16_q4
IRA Assets

IRAs continue to gain in importance as a retirement asset for individuals. IRAs have become the number #1 retirement investment vehicle with $7.9 trillion in assets at the end of the fourth quarter of 2016 (see Figure 1.2). Forty-seven percent of IRA assets, or $3.7 trillion, was invested in mutual funds, predominantly in equity funds ($1.9 trillion).

![Figure 1.2](https://www.ici.org/research/stats/retirement/ret_16_q4)

According to ICI, Individual Retirement Arrangements (IRAs) represented 31 percent of U.S. total retirement market assets of $25.3 trillion, at the end of the fourth quarter of 2016, compared with 18 percent two decades ago.

In mid-2016, 42.5 million, or 34 percent of, U.S. households reported they owned IRAs (see Figure 1.3). Traditional IRAs are the oldest and most common type of IRA. In mid-2016, 32.1 million, or 25.5 percent of, U.S. households owned Traditional IRAs. In addition to being a repository for contributions, the Traditional IRA is a vehicle for rollovers from employer-sponsored retirement plans. Indeed, more than half of U.S. households with Traditional IRAs indicated their IRAs contained rollover assets. Roth IRAs, which were first available in 1998, are the second most frequently owned type of IRA, held by 21.9 million, or 17.4 percent of, U.S. households. In mid-2016, 5.7 percent of U.S. households owned employer-sponsored IRAs, which include SEP IRAs, SARSEP IRAs, and SIMPLE IRAs.
Incidence of IRA Ownership Increases with Age and Income

People of all ages own IRAs, but ownership is greatest among the older groups of working-age individuals. This reflects the life-cycle effects on saving; that is, households tend to focus on retirement-related saving as they get older (and save for other goals such as education or buying a house when younger). Also, many Traditional IRA owners became owners as a result of rollovers from employer-sponsored plans, which occur after at least some years in the workforce. In mid-2016, 35 percent of households headed by an individual aged 45 to 54 owned IRAs, and 40 percent of households headed by an individual aged 55 to 64 owned IRAs (see Figure 1.4). As a result, 69 percent of IRA-owning households were headed by individuals aged 45 or older (see Figure 1.5). Among all U.S. households, by comparison, 62 percent were headed by individuals in this age group.
Figure 1.4
Incidence of IRA Ownership Greatest Among 35- to 64-Year-Olds
Percentage of U.S. households with in each age group that own IRAs, ¹ ² 2016

![Bar chart showing the percentage of U.S. households with IRAs by age group in 2016.](https://www.ici.org/pdf/per23-01.pdf)

¹Age is based on the age of the sole or co-decision maker for household saving and investing
²IRAs include Traditional IRAs, Roth IRAs, and employer-sponsored IRAs (SEP IRAs, SARSEP IRAs, and SIMPLE IRAs)

Source: ICI Research Perspective, Vol 23; No 1; January 2017
https://www.ici.org/pdf/per23-01.pdf

Figure 1.5
Most IRA-Owning Households Are Between 35 and 64
Percent distribution of households owning IRAs and all U.S. Households by age, ¹, ²

![Age distribution chart for IRA-owning households and all U.S. households.](https://www.ici.org/pdf/per23-01.pdf)

¹Age is based on the age of the sole or co-decision maker for household saving and investing. ²IRAs include Traditional IRAs, Roth IRAs, and employer-sponsored IRAs (SEP IRAs, SARSEP IRAs, and SIMPLE IRAs). ³The percentage of all households in each age group is based on ICI survey data and is weighted to match the U.S. Census Bureau’s Current Population Survey (CPS).

Source: ICI Research Perspective, Vol 23; No 1; January 2017
https://www.ici.org/pdf/per23-01.pdf
Figure 1.6
Incidence of IRA Ownership Increases with Household Income
Percentage of U.S. households within each income group that own IRAs, \(^2\) 2016

<table>
<thead>
<tr>
<th>Household income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$200,000 or more</td>
<td>63</td>
</tr>
<tr>
<td>$100,000 to $199,000</td>
<td>59</td>
</tr>
<tr>
<td>$75,000 to $99,000</td>
<td>38</td>
</tr>
<tr>
<td>$50,000 to $74,999</td>
<td>37</td>
</tr>
<tr>
<td>$35,000 to $49,999</td>
<td>25</td>
</tr>
<tr>
<td>$25,000 to $34,999</td>
<td>19</td>
</tr>
<tr>
<td>Less than $25,000</td>
<td>10</td>
</tr>
</tbody>
</table>

\(^1\)Total reported is household income before taxes in 2012. \(^2\) IRAs include Traditional IRAs, Roth IRAs, and employer-sponsored IRAs (SEP IRAs, SARSEP IRAs, and SIMPLE IRAs).

Source: ICI Research Perspective, Vol 23; No 1; January 2017
https://www.ici.org/pdf/per22-01.pdf

As a result, 13 percent of households owning IRAs earned less than $35,000, compared with 33 percent of all U.S. households (see Figure 1.7). Forty-three percent of households owning IRAs in mid-2016 had incomes between $35,000 and $99,999, similar to 42 percent of all U.S. households.

Figure 1.7
Most IRA-Owning Households Have Moderate Incomes
Percent Distribution of households owning IRAs and all U.S. households by Household Income, \(^1\) \(^2\) 2016

<table>
<thead>
<tr>
<th>Household income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Median: $87,500</td>
<td></td>
</tr>
<tr>
<td>Mean: $107,700</td>
<td></td>
</tr>
</tbody>
</table>

\(^1\)Total reported is household income before taxes in 2014 \(^2\) IRAs include Traditional IRAs, Roth IRAs, and employer-sponsored IRAs (SEP IRAs, SARSEP IRAs, and SIMPLE IRAs)

\(^3\) The percentage of all households in each income group is based on ICI survey data and is weighted to match the U.S. Census Bureau’s Current Population Survey.

Rollovers to Traditional IRAs Fuel Growth

As was discussed above, from their inception IRAs were designed so that investors could accumulate retirement assets either through contributions or by rolling over balances from employer-sponsored retirement plans (to help workers consolidate and preserve the tax-deferred benefit of these assets.

According to Cerulli and Associates, the growth of IRA assets has predominantly been due to rollovers from DC plan, not contributions, they reported that from 2010 to 2015 only $83 billion of the growth in Traditional IRA assets came from contributions while $2.047 trillion came from rollovers. The most recent available data show that households transferred $424 billion from employer-sponsored retirement plan to Traditional IRAs in 2014. In mid-2016, about 19 million U.S. households (or 59 percent of all U.S. households owning Traditional IRAs) had Traditional IRAs that included rollover assets (see Figure 1.8). With their most recent rollovers, the vast majority of these households (82 percent) transferred the entire plan account balance into the Traditional IRA (see Figure 1.8 Top Panel). Nearly nine in ten Traditional IRA-owning households with rollovers made their most recent rollover in 2000 or later, including 74 percent whose most recent rollover was within the past 11 years. Among households with rollovers in their Traditional IRAs, 52 percent only had rollover IRAs, (having never made Traditional IRA contributions (see Figure 1.8 Mid Panel).

**Figure 1.8**
Rollovers Are Often a Source of Assets for Traditional IRAs

<table>
<thead>
<tr>
<th>Households with Traditional IRAs that include rollovers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Percentage of households owning Traditional IRAs, 2016</strong></td>
</tr>
<tr>
<td>Traditional IRA includes rollover</td>
</tr>
<tr>
<td>Traditional IRA does not include rollover</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Traditional IRA rollover activity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Percentage of households owning Traditional IRAs that include rollovers, 2016</strong></td>
</tr>
<tr>
<td>Traditional IRA rollover(s) due to *</td>
</tr>
<tr>
<td>Job change, layoff, or termination</td>
</tr>
<tr>
<td>Retirement</td>
</tr>
<tr>
<td>Other</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contributions to Traditional IRA other than rollover</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Percentage of households owning Traditional IRAs that include rollovers, 2016</strong></td>
</tr>
<tr>
<td>Have made contribution other than rollover</td>
</tr>
<tr>
<td>Have never made contribution in addition to rollover</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Percentage of Traditional IRA balance from rollovers or transfers from former employer-sponsored retirement plan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Median percentage of Traditional IRA balance from rollovers or transfers from former employer-sponsored retirement plans</strong></td>
</tr>
<tr>
<td>Less than 25 percent</td>
</tr>
<tr>
<td>25 to 49 percent</td>
</tr>
<tr>
<td>50 to 74 percent</td>
</tr>
<tr>
<td>75 percent or more</td>
</tr>
</tbody>
</table>

Most Traditional IRA-owning households with rollovers had multiple reasons for rolling over the accumulations from their employer-sponsored retirement plans to Traditional IRAs (see Figure 1.9). For example, 64 percent did not want to leave assets with their former employer and 63 percent said they wanted to preserve the tax treatment of the savings. Fifty-eight percent rolled over to get more investment options. Fifty-seven percent of Traditional IRA-owning households with rollovers indicated that consolidating assets was one of the reasons for the rollovers. Forty-four percent kept their assets with the same financial services provider when they rolled over assets, and 37 percent rolled over to change financial services providers. Twenty-two percent thought it was easier to roll over to an IRA than into their new employer’s plan. Forty-seven percent indicated they were required to take all of their money out of their former employer’s plan.

**Figure 1.9**

*Reasons for Most Recent Rollover*

<table>
<thead>
<tr>
<th>Reason for most recent rollover</th>
<th>Primary reason for most recent rollover</th>
</tr>
</thead>
<tbody>
<tr>
<td>Did not want to leave assets with the former employer</td>
<td>64</td>
</tr>
<tr>
<td>Wanted to preserve tax treatment of the savings</td>
<td>63</td>
</tr>
<tr>
<td>Wanted more investment options</td>
<td>58</td>
</tr>
<tr>
<td>Wanted to consolidate assets</td>
<td>57</td>
</tr>
<tr>
<td>Were required to take all money out of the former employer’s plan</td>
<td>47</td>
</tr>
<tr>
<td>Wanted to keep assets with the same financial services provider</td>
<td>44</td>
</tr>
<tr>
<td>Wanted to use a different financial services provider</td>
<td>37</td>
</tr>
<tr>
<td>Were told by a financial adviser to roll over assets</td>
<td>31</td>
</tr>
<tr>
<td>Thought it was easier to roll over assets to an IRA than into the new employer’s plan</td>
<td>22</td>
</tr>
<tr>
<td>Wanted the same investments that were in the former employer’s plans</td>
<td>8</td>
</tr>
</tbody>
</table>

Multiple responses are included for all responses except for respondents who were required to take the money out of their former employer’s plan.

*Source: ICI Research Perspective, Vol 23; No 1; January 2017*

https://www.ici.org/pdf/per23-01.pdf

Most Traditional IRA-owning households generally researched the decision to roll over money from their former employer’s retirement plan into a Traditional IRA. Seventy-seven (77) percent consulted multiple sources of information—the most common source of information was professional financial advisors, who were consulted by 61 percent of Traditional IRA-owning households with rollovers (see Figure 1.10). Nearly four in 10
Traditional IRA-owning households with rollovers relied on information provided by their employers, with 31 percent of Traditional IRA-owning households with rollovers using printed materials from their employers as a source of information. Sixty-four percent indicated they relied on information provided by a financial services firm, with 38 percent using printed materials provided by financial services firms. Twenty-eight percent indicated they used online materials from financial services firms.

When asked to identify their primary source of information on the rollover decision, half of Traditional IRA-owning households with rollovers indicated they primarily relied on professional financial advisors; older households were more likely to consult professional financial advisors than younger households (see Figure 1.10 second panel). Nineteen percent of Traditional IRA-owning households with rollovers indicated their primary sources of information were financial services firms. Seven percent of Traditional IRA-owning households with rollovers indicated their primary source of information was online materials from these firms, with younger households more likely to rely on online resources than older households.

Figure 1.10
Sources of Information Consulted for Rollover Decision
Percentage of Traditional IRA owning households with rollovers, 2016

<table>
<thead>
<tr>
<th>Age of Head of Household¹</th>
<th>All</th>
<th>Younger than 50</th>
<th>50 to 59</th>
<th>60 to 69</th>
<th>70 or older</th>
</tr>
</thead>
<tbody>
<tr>
<td>Your spouse or partner</td>
<td>6</td>
<td>6</td>
<td>5</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>A coworker, friend, or family member</td>
<td>6</td>
<td>11</td>
<td>5</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Your employer (printed or online materials, seminars, workshops)</td>
<td>10</td>
<td>13</td>
<td>9</td>
<td>11</td>
<td>8</td>
</tr>
<tr>
<td>A seminar or workshop sponsored by employer</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Printed materials provided by your employer</td>
<td>4</td>
<td>4</td>
<td>6</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Online materials from your employer</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>(*)</td>
</tr>
<tr>
<td>Financial services firms (printed or online materials, seminars, workshops)</td>
<td>19</td>
<td>25</td>
<td>20</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>A seminar or workshop sponsored by employer</td>
<td>1</td>
<td>(*)</td>
<td>(*)</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Printed materials provided by your employer</td>
<td>4</td>
<td>4</td>
<td>6</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Online materials from your employer</td>
<td>7</td>
<td>13</td>
<td>6</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>A phone representative from a financial services firm</td>
<td>7</td>
<td>8</td>
<td>8</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>The IRS rules of publications</td>
<td>6</td>
<td>6</td>
<td>9</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>A professional financial advisor</td>
<td>50</td>
<td>37</td>
<td>49</td>
<td>55</td>
<td>59</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td><strong>Number of respondents</strong></td>
<td>1,357</td>
<td>347</td>
<td>343</td>
<td>408</td>
<td>259</td>
</tr>
</tbody>
</table>

¹ Age is based on the age of the sole or co-decision maker for household saving and investing.
² Multiple responses are included.

Note: Other responses given included: myself, other online information, bank, books and magazines, and seminars sponsored by a financial institution.

In selecting the initial asset allocation of rollover assets in Traditional IRAs, 9 percent of Traditional IRA-owning households with rollovers indicated that their professional financial advisor selected the investments, and 45 percent indicated they worked together with a professional financial advisor to select the investments. Forty-one percent of Traditional IRA-owning households with rollovers indicated that the household selected the investments without outside help.

Households with rollover assets in their IRAs tend to have higher IRA balances, compared with IRAs funded purely by individual contributions. Median Traditional IRA holdings that include rollovers were $100,000 in mid-2016, compared with median Traditional IRA holdings of $30,000 for balances that did not include rollovers (see Figure 1.11).

**Figure 1.11**
Traditional IRAs Preserve Assets from Employer-Sponsored Retirement Plans
*(Traditional IRA assets by employer-sponsored retirement plan rollover activity, 2016)*

<table>
<thead>
<tr>
<th></th>
<th>Traditional IRA includes rollover from employer-sponsored retirement plan¹</th>
<th>Traditional IRA does not include rollover from employer-sponsored retirement plan²</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Traditional IRA</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>$217,900</td>
<td>$84,000</td>
</tr>
<tr>
<td>Median</td>
<td>$100,000</td>
<td>$30,000</td>
</tr>
<tr>
<td><strong>Household financial Assets³</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>$484,700</td>
<td>$375,100</td>
</tr>
<tr>
<td>Median</td>
<td>$400,000</td>
<td>$260,000</td>
</tr>
</tbody>
</table>

¹ Forty-nine percent of households owning Traditional IRAs have Traditional IRAs that include rollovers from employer-sponsored retirement plans (see Figure 1.8). ² Fifty-one percent of households owning Traditional IRAs have Traditional IRAs that do not include rollovers from employer-sponsored retirement plans (see Figure 1.8). ³ Household financial assets include assets in employer-sponsored retirement plans but exclude the household’s primary residence.

Source: ICI Research Perspective, Vol 23; No 1; January 2017

**IRA Contributions**

Although IRAs can help Americans build their retirement savings, the majority of U.S. households do not contribute to them. ICI reports, that in tax year 2015 (latest data available), only 11 percent of all U.S. households made contributions to Traditional IRAs or Roth IRAs, compared with 12 percent in tax year 2014 (see Figure 1.12).
Households may, depending on their eligibility, contribute to more than one type of IRA in each tax year. Among households making contributions to IRAs in tax year 2015, 40 percent contributed to a Traditional IRA only, and half (50 percent) contributed to a Roth IRA only. The remaining 10 percent contributed to both Traditional and Roth IRAs in tax year 2015 (see Figure 1.14).
Figure 1.14
Type of IRA to which Households Contributed in Tax Year 2015
(Percentage of all U.S. Households contributing to IRAs)

- Contributed to a Traditional IRA and Roth IRA: 10%
- Traditional IRA Only: 40%
- Roth IRA Only: 50%

Source: ICI Research Perspective, Vol 22; No 1; January 2017
https://www.ici.org/pdf/per22-01.pdf

GAO Report (15-16)

A report published by the General Accounting Office (GAO) stated that in 2014, the federal government will forgo an estimated $17.45 billion in net tax revenue from IRAs. Over concerns that high income taxpayers were taking advantage of certain tax laws and benefits within IRAs, Congress requested a study to be conducted by the GAO.

According to the GAO study, of the 145 million married couples and individuals who filed individual income tax returns for tax year 2011, an estimated 43 million, or 30 percent, had IRAs with an estimated total balance—in terms of FMV reported by custodians—of $5.2 trillion at the end of 2011. About 99 percent of those taxpayers had aggregate IRA balances of $1 million or less and accounted for around 78 percent of the total balance. The median accumulated IRA balance for this group was around $34,000. Taxpayers with aggregated IRA balances exceeding $1 million, around 600,000 taxpayers, accounted for about 22 percent of total balance and had a median of around $1.4 million.

As illustrated in Table 1.16 and Table 1.17, less than 0.1 percent of taxpayers (about 6,000 to 10,000 taxpayers) had aggregated IRA balances greater than $5 million to $10 million but accounted for about 1 percent of the total balance. From around 700 to more than 1,000 taxpayers with IRA balances more than $10 million accounted for about 2 percent of the total balance. A number of taxpayers had IRA balances exceeding $25 million though this varied widely from around 115 to more than 600 taxpayers (remember Mitt Romney’s IRA).
Table 1.15
Estimated Number and Percent of Taxpayers with IRA by Size of IRA Balance,
Tax Year 2011

<table>
<thead>
<tr>
<th>IRA Balances</th>
<th>Estimated Number of Taxpayers</th>
<th>95% confidence level</th>
<th>Estimated Percent of Taxpayers with IRAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total taxpayers with IRAs</td>
<td>43,013,341</td>
<td>42,725,706</td>
<td>43,300,975</td>
</tr>
<tr>
<td>$1 million or less</td>
<td>42,382,192</td>
<td>42,094,009</td>
<td>42,670,375</td>
</tr>
<tr>
<td>&gt;$1 million to $2 million</td>
<td>502,392</td>
<td>470,897</td>
<td>533,887</td>
</tr>
<tr>
<td>&gt;$2 million to $3 million</td>
<td>83,529</td>
<td>72,632</td>
<td>94,426</td>
</tr>
<tr>
<td>&gt;$3 million to $5 million</td>
<td>36,171</td>
<td>30,811</td>
<td>41,531</td>
</tr>
<tr>
<td>&gt;$5 million to $10 million</td>
<td>7,952</td>
<td>6,120</td>
<td>9,783</td>
</tr>
<tr>
<td>&gt;$10 million to $25 million</td>
<td>791</td>
<td>596</td>
<td>985</td>
</tr>
<tr>
<td>&gt;$25 million</td>
<td>314</td>
<td>115</td>
<td>650</td>
</tr>
</tbody>
</table>


Note: The taxpayer, as a taxpaying unit, may have more than one IRA owner. The IRA balance is the aggregate value for all IRAs (including inherited IRAs) owned by the taxpayer. We assumed all blank IRA fair market values are zero; the blank values could affect these estimates considerably. Percentages may not total 100 percent due to rounding.

Table 1.16
Estimated Total and Percent of IRA FMV Balances by Size of IRA Balance,
Tax Year 2011

<table>
<thead>
<tr>
<th>IRA Balances</th>
<th>Estimated Number of Taxpayers</th>
<th>95% confidence level</th>
<th>Estimated Percent of Taxpayers with IRAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total taxpayers with IRAs</td>
<td>5,241</td>
<td>5,083</td>
<td>5,399</td>
</tr>
<tr>
<td>$1 million or less</td>
<td>4,092</td>
<td>4,038</td>
<td>4,038</td>
</tr>
<tr>
<td>&gt;$1 million to $2 million</td>
<td>674</td>
<td>632</td>
<td>632</td>
</tr>
<tr>
<td>&gt;$2 million to $3 million</td>
<td>198</td>
<td>173</td>
<td>173</td>
</tr>
<tr>
<td>&gt;$3 million to $5 million</td>
<td>133</td>
<td>114</td>
<td>114</td>
</tr>
<tr>
<td>&gt;$5 million to $10 million</td>
<td>52</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>&gt;$10 million to $25 million</td>
<td>11</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>&gt;$25 million</td>
<td>81</td>
<td>8</td>
<td>8</td>
</tr>
</tbody>
</table>


Note: The taxpayer, as a taxpaying unit, may have more than one IRA owner. The IRA balance is the aggregate value for all IRAs (including inherited IRAs) owned by the taxpayer. We assumed all blank IRA fair market values are zero; the blank values could affect these estimates considerably. Percentages may not total 100 percent due to rounding.
Chapter 1
Review Questions

1. Which of the following enacted by Congress created the Individual Retirement Arrangement (IRA)?

   ( ) A. Employee Retirement Income Security Act of 1974
   ( ) B. Social Security Act 1930
   ( ) C. Small Business Job Protection Act of 1996
   ( ) D. Tax Reform Act 1986

2. According to ICI, what percent of all U.S. households owned a Traditional IRA that included rollover assets in mid-2016?

   ( ) A. 75%
   ( ) B. 25%
   ( ) C. 88%
   ( ) D. 59%

3. Which of the following has become the number #1 retirement investment vehicle?

   ( ) A. Defined contribution (DC) plans
   ( ) B. Defined benefit (DB) plans
   ( ) C. Annuities
   ( ) D. Individual Retirement Arrangements

4. As of the fourth quarter of 2016, retirement savings accounted for what percent of all U.S. household financial assets in the United States, according to the Investment Company Institute (ICI)?

   ( ) A. 15%
   ( ) B. 31%
   ( ) C. 42%
   ( ) D. 25%

5. According to ICI, what was the percent of all U.S. households that made any type of IRA contribution in tax year 2015?

   ( ) A. 38.5%
   ( ) B. 65.0%
   ( ) C. 11.0%
   ( ) D. 48.1%
CHAPTER 2

TRADITIONAL IRA

Overview

The Traditional IRA, also known as the Original IRA and/or the Contributory IRA, was the first type of IRA authorized by Congress back in 1974. The thinking was that Social Security benefits were not going to be adequate for most Americans to retire on.

This chapter will provide an introduction to the Traditional IRA, define what is a Traditional IRA, review the myriad of rules governing the Traditional IRA – who can and cannot contribute to the Traditional IRA, and how much can be contributed.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Define and structure a Traditional IRA;
- Distinguish between a custodial IRA and a trustee IRA;
- Determine the eligibility and contribution rules for a Traditional IRA;
- Review the definition of MAGI and Phase-out rules for regular annual contributions to a Traditional IRA;
- Explain an excess contribution and the rules to remove an excess contribution; and
- Observe the rules for a Spousal Traditional IRA and contribution limits.

Setting Up a Traditional IRA

A Traditional IRA, also known as a Regular IRA or Contributory IRA, is any type of IRA, except a Roth IRA, SIMPLE IRA and/or an Educational IRA. A traditional IRA is defined and governed under IRC § 408.

There are two types of Traditional IRAs which a participant may set up and invest in:

- The Individual Retirement Account; and
- The Individual Retirement Annuity.
Although the abbreviation “IRA” may refer to either an “Individual Retirement Account” or an “Individual Retirement Annuity,” it is used primarily to refer to the far more popular form, the “individual retirement account” (as discussed below). Thus, the term “IRA annuity” may be used for convenience in distinguishing the annuity from its more popular counterpart.

**Individual Retirement Account**

An “Individual Retirement Account” (IRA), by definition [IRC § 408(a); Reg. §1.408-2], is a trust or custodial account set up in the United States for the exclusive benefit of an individual taxpayer (participant) and his or her beneficiaries.

The Individual Retirement Account is created by means of a written IRA document approved by the IRS, which can be either a custodial account or a trusteed account (non-bank).

To be a custodial account, the IRA must meet the following requirements:

- The account must have a *custodian*. This custodian must be a bank, a federally insured credit union, a savings and loan association or an entity approved by the IRS to serve as a trustee or custodian (Brokerage and Insurance companies generally fall into this general category). **Note:** An individual cannot be trustee of an individual retirement account;
- The custodian generally cannot accept regular annual contributions greater than the statutory ceiling amount of $5,500 in 2017 (same as in 2016) (IRC § 219). However, IRA rollover contributions and employer contributions to simplified employee pensions (SEP IRAs) can be more than the ceiling applicable to Traditional IRAs;
- Contributions to a Traditional IRA that do not involve rollovers must be in cash, which includes checks or money orders;
- The Traditional IRA participant must be fully “vested” in the amount in his or her IRA. This means that the participant has a non-forfeitable right to the total assets in his or her account at all times;
- Money in the Traditional IRA participant’s account cannot be used to invest in a life insurance contract;
- Assets in an IRA cannot be commingled with other property, except in a common trust fund or common investment fund;
- The IRA participant must begin receiving life expectancy or annuity payments no later than April 1 of the year following the year when he or she turns 70½; and
- Participants’ age 50 and older by the end of the tax year can make an additional catch-up contribution of $1,000 in 2017 (same as in 2016) to their individual Traditional IRA.
A non-bank trustee in addition to meeting the requirements mentioned above must demonstrate the following characteristics to the IRS:

- Fiduciary ability (including continuity of life, an established place of business in the United States where it is accessible during every business day, fiduciary experience, fiduciary responsibility, and financial responsibility);
- Capacity to account for the interest of a large number of individuals;
- Fitness to handle retirement funds;
- Ability to administer fiduciary powers; and
- Adequacy of net worth.

In addition, the non-bank trustee must also provide the following:

- Audits will be conducted by a qualified public accountant at least every 12 months;
- Funds will be kept invested as long as reasonable for the proper management of the account;
- Investments will not be commingled with other investments except in a common trust fund and investments will be safely maintained; and
- Separate fiduciary records will be maintained.

The Internal Revenue Code (IRC) states for purposes of an IRA account, a custodial account is treated as a trust and the custodian for such account is treated as a trustee [IRC § 408(h)]. The IRS maintains a list of entities approved to act as a non-bank IRA trustee or custodian.

The IRS has issued a prototype trust agreement (IRS Form 5305) and a prototype custodial agreement (IRS Form 5305A). If a banking institution or other entity wishes to use one of these agreements in lieu of preparing its own prototype agreement, the IRS prototype may be used without prior approval. On the other hand, if the institution prepares its own agreement, it must be submitted to the IRS for approval.

**Individual Retirement Annuity**

The “Individual Retirement Annuity” has the same essential tax characteristics as the Individual Retirement Account, as was discussed above, except that it is structured in the form of an annuity contract with a duly licensed life insurance company. Thus, the contributions are in the form of premiums, the accumulating assets are the cash surrender values, and the disbursements are the annuity payments (or the prior to death benefit).

Each insurance company may submit to the IRS a copy of the annuity contract that it wishes to use. After review, the IRS gives its approval and assigns a code number to the contract. For the purposes of securing this approval, IRS Form 5306 must be completed and submitted to the IRS. Because the contract received prior approval, it is not necessary for an individual to submit his or her particular IRA annuity to the IRS for approval.
The annuity contract most frequently used for IRA annuity purposes is the “flexible premium retirement annuity contract” with a normal retirement age of 65. Retirement age can, however, be any age from years 60 to 70. The contract normally calls for level premiums payable periodically (monthly, quarterly, semi-annually or annually) over the full period from issue date to retirement date. However, under the flexible premium provision, the premiums may increase or decrease in size and the frequency of premium payments may be changed from time to time. Also, the premium may be temporarily suspended or terminated completely, at the option of the owner of the contract, under what is called a stop-and-go provision.

To assure that the contract selected is an investment vehicle qualifying as an IRA annuity, the following restrictions must be incorporated into the contract and made an integral part of it [IRC § 408(b)]:

- The annual premium on behalf of any individual must not exceed the dollar amount of $5,500 in 2017 (same as in 2016) (IRC § 219(b)(1)(A));
- The contract must be non-assignable, non-alienable and non-transferable by the individual (except as to the tax-free rollover privilege);
- The entire value of the contract must be non-forfeitable to the individual;
- Any and all dividends (called “refunds of premiums”) must be applied before the end of the succeeding calendar year to purchase additional benefits or to reduce future premiums; and
- Distributions from the contract prior to or at retirement or at death must be made in accordance with the distribution rules applicable to qualified plans generally [under IRC § 401(a)(9)].

Annuity payments may commence without a penalty at any age from 59½ to April 1 of the year following the attainment of age 70½, usually on a monthly basis. Of course, various optional types of annuity settlements are usually available on request. The amount of the annuity payment depends upon the amount of the premiums actually paid. The death benefit prior to the commencement of the annuity payments is most often the aggregate of the premium payments or the cash surrender value, if greater.

Note: For an IRA annuity, in lieu of a single life annuity contract on the life of the individual, it is permissible for the contract to be applied for and issued in the form of a joint and survivor annuity on the lives of the contract owner and his or her spouse. Under a regular qualified pension plan, ERISA requires the normal type of retirement settlement to be a joint and survivor annuity, unless the retiring employee specifically elects otherwise. This requirement, however, is not imposed upon an IRA annuity.

Traditional IRA Eligibility Requirements

There are two requirements a participant must meet to be eligible for a Traditional IRA.
First, he/she must be under age 70½. A participant cannot contribute to a Traditional IRA during or after the tax year in which he/she reaches age 70½; and

Second, the participant must have taxable compensation in order to contribute to a Traditional IRA or Roth IRA.

Compensation Defined

Under IRC §219(f)(1), the categories of compensation are defined as follows:

- **Wages, salaries, etc.** Wages, salaries, tips, professional fees, bonuses, and other amounts a participant receives for providing personal services are compensation. The IRS treats as compensation any amount properly shown in Table 2.1 (Wages, tips, other compensation) from Form W-2, Wage and Tax Statement, provided that amount is reduced by any amount properly shown in box 11 (Non-qualified plans). Scholarship and fellowship payments are compensation for IRA purposes only if shown in box 1 of Form W-2;

- **Commissions.** The amount a participant receives that is a percentage of profits or sale price is compensation;

- **Self-employment income.** If the participant is self-employed (a sole proprietor or a partner), compensation is the net earnings from their trade or business (provided personal services are a material income-producing factor) reduced by the total of:
  - The deduction for contributions made on their behalf to retirement plans;
  - and
  - The deduction allowed for one-half of their self-employment taxes.

Compensation includes earnings from self-employment even if the participant is not subject to self-employment tax because of their religious beliefs. When a participant has both self-employment income and salaries and wages, their compensation includes both amounts;

- **Self-employment loss.** If a participant has a net loss from self-employment, do not subtract the loss from their salaries or wages when figuring their total compensation. However, net losses from one self-employed business may be aggregated with net income from another self-employed business;

- **Alimony and separate maintenance.** For Traditional IRA purposes (also Roth IRA), compensation includes any taxable alimony and separate maintenance payments one may receive under a decree of divorce or separate maintenance; and

- **Non-taxable combat pay.** If the taxpayer was a member of the U.S. Armed Forces, compensation includes any non-taxable combat pay he/she received. Under the Heroes Earned Retirement Opportunities (HERO) Act, signed into law by President Bush May 29, 2006, military personnel can now count tax-free combat pay when determining whether they qualify to contribute to a traditional (or Roth IRA). Before this change, members of the military whose earnings came entirely from tax-free combat pay were generally barred from using IRAs to save for retirement. This amount should be reported in box 12 of their Form W-2 with code Q.
Table 2.1
Compensation for purposes of an IRA

<table>
<thead>
<tr>
<th>Includes…</th>
<th>Does not include…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages, salaries, etc.</td>
<td>Interest and dividend income</td>
</tr>
<tr>
<td>Self-employment income</td>
<td>Earnings and profits from property</td>
</tr>
<tr>
<td>Commissions</td>
<td>Pension and annuity income</td>
</tr>
<tr>
<td>Alimony separate maintenance</td>
<td>Deferred compensation</td>
</tr>
<tr>
<td>Non-taxable combat pay</td>
<td>Income from certain partnerships</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590

On the other hand, compensation does not include any of the following items:

- Earnings and profits from property, such as rental income, interest income, and dividend income;
- Pension or annuity income;
- Deferred compensation received (compensation payments postponed from a past year);
- Income from a partnership for which the individual does not provide services that are a material income-producing factor;
- Any amounts excluded from income, such as foreign earned income and housing costs; and
- Unemployment compensation.

**Regular Annual IRA Contributions**

Under IRC § 219(b)(1)(A), there is a limit on the amount of a regular contribution the participant may make to a Traditional IRA each tax year. The rule states that any participant with taxable compensation can contribute to their Traditional IRA up to 100 percent of their taxable compensation up to a maximum. Table 2.2 shows the maximum contribution limits for 2016 and 2017.

Table 2.2
Regular Annual Contribution Limit

<table>
<thead>
<tr>
<th>Year</th>
<th>Dollar Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$5,500</td>
</tr>
<tr>
<td>2017</td>
<td>$5,500</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590

Under IRC § 219 (b)(5)(B), there is a catch-up provision that allows individuals who have reached age 50 and older to make an additional contribution. Table 2.3 shows the maximum catch-up contribution limits for 2016 and 2017.
### Table 2.3

**Catch-up Contribution Limit**

<table>
<thead>
<tr>
<th>Year</th>
<th>Dollar Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$1,000</td>
</tr>
<tr>
<td>2017</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590

For 2017 (same as in 2016), the maximum contribution for a participant age 50 and older will be $6,500.

**Note:** Regular annual contributions must be in the form of money (cash, check, or money order). Property cannot be contributed. However, an individual may transfer or roll over certain property (other than cash) from one retirement plan to the other.

### Date of Regular Annual IRA Contributions

Regular annual contributions can be made to a Traditional IRA for a year at any time during the year or by the due date for filing the return for that year, not including extensions. Normally, the deadline is April 15\textsuperscript{th} of the year following the tax year. However, under IRC § 7503, whenever the tax deadline falls on a Saturday, Sunday or a legal holiday, the tax deadline is moved to the next business day. This means:

- For tax year 2016, the tax deadline falls on April 18, 2017; and
- For tax year 2017, the tax deadline will fall on April 17, 2018.

### Contributions Returned Before Due Date of Return

If an IRA participant makes a regular annual contribution to his or her Traditional IRA, the participant can withdraw those contributions tax free by the due date of their return. If the participant has an extension of time to file their return, the participant can withdraw them tax free by the extended due date. The participant can do this if, for each regular annual contribution he/she withdraws, both of the following conditions apply:

- Participant did not take a deduction for the contribution; and
- Participant withdraws any interest or other income earned on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income earned on the contribution may be a negative amount.

### IRA Deductible Contributions

Deductible regular annual contributions a taxpayer can to his/her Traditional IRA depends on whether he/she (and spouse if applicable) is covered for any part of the year by an employer retirement plan. If the taxpayer (and spouse, if applicable) is not covered
by a qualified retirement plan, he/she is allowed to deduct 100% of his or her maximum allowable contribution. However, an employee who participates in a qualified retirement plan, the deduction will be subject to the phase-out rules. But, let’s first define an active participant.

**Active Participant Defined**

Special rules apply to determine whether a participant (employee) is covered by (active participant) an employer-sponsored retirement plan for a tax year. These rules differ depending on whether the plan is a defined contribution plan or a defined benefit plan.

- **Defined Contribution (DC) Plan.** Generally an employee is considered covered by a defined contribution plan if amounts are contributed or allocated to the employee’s account for the plan year that ends within their tax years. Types of DC plans include profit sharing (PS) plans, stock bonus plans, money purchase plans, 401(k) plan, 403(a) plan, 403(b) plan, a SEP IRA and SIMPLE IRA.

  **Note:** If an amount is allocated to the employee’s account for a plan year, the employee is considered covered by the plan (active participant) even if they are not vested in the plan; and

- **Defined Benefit (DB) Plan.** If an employee is eligible (meets minimum age and years of service requirements) to participate in their employer’s DB plan for the plan year that ends within their tax year, they are considered covered by the plan. This rule applies even if the employee declined to be covered by the plan, they did not make a required contribution, or they did not perform the minimum service required to accrue a benefit for the year. A DB plan is any plan that is not a DC plan. Contributions to a DB plan are based on a computation of what contributions are necessary to provide definite benefits to plan participants. DB plans include pension plans and annuity plans.

  **Note:** If the employee accrues a benefit for a plan year, the employee is covered by that plan even if the employee has no vested interest in (legal right to) the accrual. For those who would not be considered covered by an employer plan are the following:

  - **Social Security or Railroad Retirement.** Coverage under Social Security or Railroad Retirement (Tier I and Tier II) does not count as coverage under an employer retirement plan; and

  - **Reservists.** If the only reason an employee participates in a plan is because he or she is a member of a reserve unit of the armed services, they may not be considered covered by a plan. The reservist will not be considered covered by the plan if both of the following conditions are met:

    - The plan he or she participates in is established for its employees by:
      - The United States;
      - A state or political subdivision of a state; or
      - An instrumentality of either both of the above.
Volunteer Firefighters. If the only reason an employee participates in a plan is because they are a volunteer firefighter, they may not be considered covered by the plan. The volunteer firefighter would not be considered covered by the plan if both of the following conditions are met:

- The plan the volunteer firefighter participates in is established for its employees by:
  - The United States;
  - A state or political subdivision of a state; or
  - An instrumentality of either both of the above.
- The accrued retirement benefits at the beginning of the year will not provide more than $1,800 per year at retirement; and
- The employee has not served more than 90 days on active duty.

A simpler way to find out if the participant is an active participant in an employer-sponsored qualified retirement plan is to review their Form W-2 they received from their employer. On the Form W-2 there is a “Retirement Plan” box (Box 13) used to indicate whether or not the employee is covered (active participant) for the year. If the box is checked, then the employee is an active participant for the current tax year.

**Deduction Phase-out**

If the participant is an “active participant” in certain employer retirement plans, the total regular annual contribution limit is subject to phase-out based upon Modified Adjusted Gross Income (MAGI) for purpose of the deductible contribution limit [IRC § 219(g)]. Their deduction is also affected by how much income they had and by their filing status. The deduction may also be affected if they received any Social Security benefits.

The deduction will begin to decrease (phase-out) when their MAGI rises above a certain amount and is eliminated altogether when it reaches a higher amount. These income limits will vary depending on the filing status [IRC § 219(g)(3)(b)].

To determine if a participant’s regular annual contribution deduction is subject to the phase-out, you must first determine their MAGI and their filing status. Once you have determined, you can use Tables 2.4 and 2.5 to determine if the phase-out applies.

Thus, in the case of an active participant, the total contribution limit amount is phased-out by an amount equal to such amount multiplied by the ratio of the individual’s MAGI in excess of an applicable dollar amount to $10,000 ($20,000 in case of a joint return).

\[
\text{Total contribution limit} \times \frac{\text{MAGI} - \text{applicable dollar amount}}{\$10,000} = \text{reduction}
\]

Whenever the phase-out reduction is other than a multiple of $10, the reduction is rounded to the next lowest multiple of $10. However, where the total contribution limit amount adjusted for phase-out based upon MAGI is between $0 and $200, $200 is allowable as a deduction.
### Table 2.4
**Effect of MAGI on Deduction**

*If an Active Participant*

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>And MAGI is...</th>
<th>2016</th>
<th>2017</th>
<th>Allowed Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Single, Head of Household, or Qualifying Widow(er)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$61,000 or less</td>
<td>$62,000 or less</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>More than $61,000 but less than $71,000</td>
<td>More than $62,000 but less than $72,000</td>
<td>Partial</td>
<td></td>
</tr>
<tr>
<td></td>
<td>More than $71,000</td>
<td>More than $72,000</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td><strong>Married Filing Jointly or Qualifying Widow(er)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$98,000 or less</td>
<td>$99,000 or less</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>More than $98,000 but less than $118,000</td>
<td>More than $99,000 but less than $119,000</td>
<td>Partial</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$118,000 or more</td>
<td>$119,000 or more</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td><strong>Married Filing Separately</strong></td>
<td>Less than $10,000</td>
<td>Less than $10,000</td>
<td>Partial</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>$10,000 or more</td>
<td>None</td>
<td></td>
</tr>
</tbody>
</table>

* If the individual did not live with his or her spouse at any time during the year, their filing status is considered Single for this purpose.

Source: IRS Pub. 590

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**MAGI Defined**

MAGI is a measure of income used to determine how much of a deductible contribution can be made to a Traditional IRA. The IRS says that MAGI for Traditional IRA purpose is Adjusted Gross Income (AGI) as shown on line 37 of the 1040 adding the following items:

- AGI shown on line 21, Form 1040A, or line 37, Form 1040 figured without taking into account line 17, Form 1040A, or line 32, Form 1040;
- Add any student loan interest deduction from line 18, Form 1040A, or line 33, Form 1040;
- Add any tuition and fees deduction from line 19, Form 1040A, or line 34, Form 1040;
- Add any domestic production activities deduction from line 35, Form 1040;
- Add any foreign earned income exclusion and/or housing exclusion from line 18, Form 2555-EZ, or line 43, Form 2555;
- Add any foreign housing deduction from line 48, Form 2555;
- Add any excluded qualified savings bond interest shown on line 3, Schedule 1, Form 1040A, or line 3, Schedule B, Form 1040 (from line 14, Form 8815); and
• Add any exclusion of employer-provided adoption benefits shown on line 30, Form 8839. This is your Modified AGI for Traditional IRA purposes.

Table 2.5 shows the effect of the MAGI phase-out rule when a married couple, who either live with their spouse, or file a joint return where only one spouse is an active participant.

### Table 2.5
**Effect of MAGI on Deduction When One Spouse is not an Active Participant***

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>And MAGI is...</th>
<th>Allowed Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2016</td>
<td>2017</td>
</tr>
<tr>
<td>Married Filing Jointly or Separately with a spouse who is not covered by a plan at work.</td>
<td>$184,000 or less</td>
<td>$186,000 or less</td>
</tr>
<tr>
<td></td>
<td>More than $184,000 but less than $194,000</td>
<td>More than $186,000 but less than $196,000</td>
</tr>
<tr>
<td>Married Filing Jointly with a spouse who is covered by a plan at work.</td>
<td>$194,000 or more</td>
<td>$196,000 or more</td>
</tr>
<tr>
<td>Married Filing Separately with a spouse who is covered by a plan at work. **</td>
<td>$10,000 or less</td>
<td>$10,000 or more</td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>$10,000 or more</td>
</tr>
</tbody>
</table>

* Entitled to a full deduction. If participant did not live with his/her spouse at any time during the year.

Source: IRS Pub. 590.

### Non-Deductible Annual IRA Contributions

The *Tax Reform Act of 1986* opened the door for any taxpayer under the age of 70 ½ with earned (income) compensation to make non-deductible (after-tax) contributions (irrespective of retirement plan coverage).

Similar to making deductible regular contributions to a Traditional IRA (as discussed above), non-deductible regular annual contributions to Traditional IRAs (and non-deductible employee contributions to a SEP IRA) are subject to the same combined overall limitation equal to the lesser of the total contribution limit or compensation includable in income. This amount is reduced by any deductible contributions to a Traditional IRA or SEP IRA. However, non-deductible contributions to a Traditional IRA or SEP IRA are not subject to any phase-out based upon MAGI even if the participant (employee) is an active participant in certain employer retirement plans.
**Note:** Non-deductible regular annual contributions cannot be made to a Traditional IRA or SEP IRA in taxable years once the individual has attained age 70½.

When an individual makes non-deductible IRA regular annual contributions they must file IRS Form 8606 even if they do not have to file a tax return for the year. If not, all of the contributions to their Traditional IRA will be treated as deductible. All distributions taken from their Traditional IRA will be taxed (see Chapter 6). Also, there will be a $50 penalty for failure to file the required Form 8606.

**Excess Contributions**

What is an excess contribution? IRC § 4973(b) defines an excess contribution to a Traditional IRA as the portion of an individual’s regular annual contribution amount for a taxable year that exceeds the maximum allowable contributions under IRC § 219.

Excess contributions typically occur when:

- A contribution to a Traditional IRA exceeds the 100 percent of compensation or the maximum contribution limit of $5,500 ($6,500 with catch-up contribution) in 2017 (same as in 2016). Similar rules for Spousal IRA;
- Contributions are made to a Traditional IRA after the participant has attained the age of 70½;
- Regular annual contributions to a SEP IRA or SIMPLE IRA plan exceeds allowable limits or a contribution is made for an ineligible employee; and
- An improper rollover contribution is made.

**Penalty for Excess Contribution**

Under IRC § 4973, a six (6) percent penalty tax is imposed on excess contributions to a Traditional IRA if the excess contributions for the year are not withdrawn by the date of filing the federal tax return for the year (including extensions). The penalty applies for each year the excess remains in the IRA.

**Note:** Earnings include both price fluctuations and fund distributions (dividends and capital gains). This method requires that the excess contribution earnings be calculated based on the entire value of all IRAs.
Once an excess contribution has been made to a Traditional IRA, the participant has until the tax-filing deadline (plus extensions) to remove excess contributions [IRC § 408 (d)(4)]. Earnings must also be removed.

If the participant misses the deadline, he/she will owe an excess penalty tax of 6% of the excess amount annually until the excess is removed. If the participant filed his/her taxes on time without requesting an extension, he/she can still remove the excess and file a technical correction to their tax return by October 15th. This does not apply to taxpayers who were simply late filing taxes and did not request an extension.

Frequently, a participant will make a regular annual contribution to his/her Traditional IRA, which is then invested, and then wishes to remove the specific quantity of the investment to correct the excess. This is incorrect. Gains and losses are allocated according to a pro-rated formula for the entire account. Once the dollar amount that must be removed is determined, the individual may then choose to correct the excess by removing cash or any combination of securities that will total the amount that must be removed.

**Note:** IRS Form 8606 must be completed when taking withdrawals from the Traditional IRA.

**Example:** On January 2, 2017, an individual had a Traditional IRA with a value of $56,000. The individual made a $4,000 contribution for 2017 that day, bringing the total account value to $60,000 and also bought 400 shares of Ace Company at $10 a share. On January 2, 2018 the individual realizes that he cannot make a 2017 contribution, and would like to withdraw the 400 shares of Ace Company (worth $2,000). Ace stock is currently trading at $5 dollars a share, and the total value of the Traditional IRA is $63,000.

- **Step1:** Determine the percentage gain/loss on the entire account:

  \[
  \frac{\$63,000 - \$60,000}{\$60,000} = 0.05 = 5\% \text{ gain since the contribution was received}
  \]

- **Step 2:** Determine the amount that must be withdrawn:

  \[
  \$4,000 \times 1.05 = \$4,200
  \]

It is important to note that if only a portion of the contribution was an excess, apply the gain/loss percentage only to the amount that represents the amount of the excess.

The participant must withdraw $4,200. $200 will be subject to tax, and possibly, a 10% penalty depending on whether the individual is age 59 ½ or younger. In the above
example, removing the 400 shares of Ace (worth $2,000) would not be enough to correct the excess contribution.

The excess may be reallocated to a contribution for an open tax year (i.e. current or prior year contribution) if the maximum for that contribution year has not yet been met. In our example, the participant could ask to reallocate the $4,200 to a 2017 contribution. Most custodians would not make the participant take a distribution of excess and then write them another check. However, this would still be reported as 2 transactions: a distribution of excess ($4,000 contribution plus $200 earnings), and a 2017 contribution for $4,200.

Other important things you need to remember about the excess tax penalty:

- It is cumulative and imposed each year the excess remains in the IRA;
- It is non-deductible; and
- It is always imposed on the participant, not the IRA custodian or trustee.

**Tax Reporting**

To pay the 6 percent penalty tax under IRC § 4973, the participant must complete IRS Form 5329, *Additional Taxes on Qualified Plans (including IRAs) and Other Tax Favored Accounts*, and attach it to his or her federal income tax return. Part III is for Traditional IRA excess contributions.

Also, IRS Form 1099-R, will be issued for the year in which the excess contribution was removed from the IRA. For a withdrawal of an excess contribution, plus earnings, there is a distribution code of either “8” or “P” reported on IRS Form 1099-R. If an excess contribution is removed without earnings, then a code of “1” or “7” is used, depending on the age of the participant. These codes are explained in the IRS instructions for Forms 1099-R, 5498 and 5329. Additional information can be found in IRS Publication 590.

**Spousal IRA**

The Spousal IRA, also considered a Traditional IRA or Roth IRA, allows a married participant with taxable compensation whose spouse has no taxable compensation, to contribute to a Traditional IRA for the benefit of both the individual and his or her spouse. The Spousal IRA is subject to special contribution limits, which are different from those that may apply to Traditional or Roth IRAs.

**Contributions Limits to Spousal IRA**

For 2017 (same as in 2016), a married individual can contribute the lesser of their earnings or $5,500 to a Spousal IRA. If their spouse is 50 years old or over, he or she can contribute an additional $1,000.
An exception to the Spousal IRA is that a contribution can be made by the spouse with compensation who is over age 70½ for the benefit of the spouse who is under age 70½.

**Deduction Limits for Spousal IRA**

If a spouse is not covered by a retirement plan at work, she/he may be able to deduct the full amount of their Spousal IRA from their income tax return. If the spouse is covered by a retirement plan, their Spousal IRA is fully deductible if their MAGI is less than $186,000 in 2017 (increased from $184,000 in 2016); and partially deductible if their MAGI is $186,000 - $196,000 in 2017 (increased from $184,000 - $194,000 in 2016).

**Setting up the Account**

A Spousal IRA must be in the spouse’s name. Joint accounts are not allowed even though the spouse with compensation is making the contribution.

**Deduction of Fees**

Brokers’ commissions paid in connection with a Traditional IRA are subject to the contribution limit. These commissions are part of an IRA contribution and, as such are deductible subject to the limits.

**Note:** Trustees’ administrative fees are not subject to the contribution limit.
Chapter 2
Review Questions

1. A Traditional IRA is defined and governed under which Section of the Internal Revenue Code (IRC)?

(   ) A. IRC § 408
(   ) B. IRC § 401(a)
(   ) C. IRC § 403(b)
(   ) D. IRC § 457(b)

2. An individual CANNOT establish or contribute to a Traditional IRA during or after the tax year in which he/she reaches what age?

(   ) A. 59½
(   ) B. 70½
(   ) C. 70
(   ) D. 72

3. Which of the following is NOT considered taxable compensation when contributing to a Traditional IRA?

(   ) A. Bonuses
(   ) B. Salaries
(   ) C. Rental income
(   ) D. Wages

4. Contributions to a Traditional IRA can generally be made up until which of the following dates?

(   ) A. The due date for filing the return (not including extensions)
(   ) B. The due date for filing the return (including extensions)
(   ) C. December 31st of the current tax year
(   ) D. October 15th of the tax year following the tax year required for filing the tax return

5. What is the maximum catch-up provision amount for a Traditional IRA in 2017?

(   ) A. $ 550
(   ) B. $2,500
(   ) C. $1,500
(   ) D. $1,000
CHAPTER 3

SIMPLIFIED EMPLOYEE PENSION PLAN (SEP IRAs)

Overview

A Simplified Employee Pension (SEP) plan allows an employer to make contributions to a Traditional IRA established by each of their employees without being confined by the complex rules governing qualified retirement plans.

This chapter will provide an in depth review of the SEP IRA. It will review the legislative background and intent of the SEP IRA, the advantages and disadvantages, as well as the myriad of rules, eligibility and contribution limits. This chapter will also review the SARSEP IRA.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Define a Simplified Employee Pension Plan (SEP IRA);
- Distinguish between a SEP IRA and a Traditional IRA;
- Outline the advantages and disadvantages of the SEP IRA for the employer and the employee;
- List the steps an employer must take in order to set up a SEP IRA;
- Determine eligibility for employer and employee participation, contributions and limits; and
- Identify the differences between a SARSEP IRA and a SEP IRA.

SEP IRA Background

Simplified Employee Pension Individual Retirement Arrangement (SEP IRA) came into law with the passage of The 1978 Tax Revenue Act. A SEP IRA is designed to help smaller employers establish a retirement plan for their employees without the administrative costs and governmental paperwork that burden most qualified plans.

A SEP IRA consists of a special Individual Retirement Account established and maintained solely by the employee but to which his or her employer can contribute. Eligibility requirements, contribution limits and many other features associated with a qualified plan are applicable in the case of a SEP IRA, but with some major differences. A SEP IRA has the administrative simplicity of an Individual Retirement Arrangement,
but also has a higher contribution limit. SEP IRAs are defined and governed under IRC § 408(k).

**SEP IRA Advantages**

SEP IRAs carry three prime advantages. They are:

- First, they have tax advantages for both the employer and the employee;
- Secondly, they are simple to establish and operate; and
- Thirdly, they allow plan participants the ability to select the investment options that meet their budget and retirement objectives.

Let’s review in greater detail some of the tax advantages and non-tax advantages for both the employer and employee.

**Tax Advantages for the Employer**

A SEP IRA has some attractive tax advantages. First, all employer contributions to the plan are tax deductible as an ordinary and necessary business expense. In addition, the SEP IRA is a remarkably flexible plan because employer contributions are not required every year. Contributions may vary from year to year in dollar amount, provided that the percentage-of-compensation, (contributed for each person covered by the plan) is the same for each participant. The compensation on which the deductible contribution is based must be for services actually performed by the employee.

A SEP IRA may be established and receive deductible contributions after the close of the tax year (prior to the due date for the tax return), whereas a regular qualified plan cannot.

**Tax Advantages for the Employee**

Employer contributions to a SEP IRA are not taxable income to the employee. Regular SEP IRA contributions are also free of FICA and FUTA taxes.

**Non-Tax Advantages for the Employer**

In addition to the tax advantages, there are several non-tax advantages when an employer establishes a SEP IRA. These advantages are essentially the same as when a qualified plan is offered, but with greater simplicity and lower administrative cost:

- *Having a specialized retirement plan.* Employers who want their employees to have a retirement plan identical in scope and coverage to the pension plans found in the larger corporations can establish a SEP IRA that meets those expectations. With a SEP IRA, the employer can offer the employee future retirement security;
The ability to attract and retain employees. An employer operating in today’s labor market must be able to provide prospective and current employees with a retirement program similar to, if not better than, the plans being offered by competitors; and

Increasing productivity and reducing turnover. Costs of production in today’s business arena are a vital factor in determining whether a business will be successful. If an employer can satisfy employee concerns regarding retirement planning, individual and company productivity will increase because employees will stay with that employer. Because of reduced employee turnover, training and recruiting costs are reduced, which leads to higher profit at year-end.

The fact that the employees choose their own investment vehicles means that the employer’s fiduciary duty in that regard is alleviated.

Disadvantages of a SEP IRA

Although SEP IRA plans offer the advantages of greater simplicity and reduced administrative cost, as compared with full-blown qualified plans, they are not totally free of administrative oversight burdens. For example, as discussed below, they are subject to minimum eligibility requirements and testing rules for nondiscrimination in favor of highly compensated employees (HCE). Smaller businesses may not wish to deal with even this level of administrative responsibility.

SEP IRAs have some disadvantages, compared with qualified plans. For example, participants in a SEP IRA must be fully vested in their accounts at all times. Under a qualified plan, the employer can structure the plan to phase-in the vesting based upon the employee’s length of service. SEP IRA coverage requirements are generally broader, and thus, a SEP IRA can be more costly since it may require coverage of certain employees that are not required to be covered under a qualified plan. For example, a company that utilizes part-time or seasonal workers on a repeat basis may be required to include them in a SEP IRA plan, whereas they could be excluded from a qualified plan.

SEP IRA Participation Requirements

An employer who establishes and makes annual contributions to a SEP IRA must include all qualifying employees in the plan. Qualifying employees are employees who:

- Attained age 21 [IRC § 408(k)(2)(A)];
- Performed service for the employer during at least three of the preceding five calendar years (though the employer can elect a shorter waiting period) [IRC § 408(k)(2)(B)]; and
- Received at least $600 compensation in 2017 (same as in 2016) from the employer for the calendar year [IRC § 408 (k)(2)(C)].
A self-employed person or a partner in a partnership is considered to be an employee for SEP IRA purposes; however, a self-employed person or a partner must satisfy the same participation requirements and receive the same benefits as any other employee.

If an employer has union employees, it may be possible to exclude them from a SEP IRA. The law permits the exclusion of employees who have bargained in good faith under a collective bargaining agreement. It is necessary for an employer to be able to prove that, in fact, such bargaining did take place.

If an employer has an employee who is a non-resident alien situated in a foreign country with no earned income in the United States, the employee may be excluded from a SEP IRA.

**Self-Employed Individuals**

Included in the definition of the term “self-employed individual” is a sole proprietor of an unincorporated trade or business enterprise. Also included is an unincorporated professional individual (e.g., physician, attorney, dentist, accountant, etc.). A partner in a partnership operating a trade or business enterprise or a professional corporation is also included in the term self-employed individual, regardless of the extent of his or her interest in the partnership.

For purposes of a SEP IRA, a self-employed person is considered to be an employee as well as the employer. In the case of a partnership, the partnership is the employer and each partner in the partnership is considered to be an employee for SEP IRA purposes.

**Establishing a SEP IRA Plan**

When an employer decides to establish a SEP IRA, the employer is required to prepare and formally adopt a written program document. This document must, at a minimum, specify the name of the employer, the requirements for employee participation, the signature of a responsible official, and the formula for allocation of contributions [Prop. Reg. §1.408-7(b)]. The plan may be established by use of the IRS model SEP on Form 5305-SEP, by adoption of a prototype plan (usually offered by financial institutions) that has been reviewed and approved by the IRS, or by adoption of an individually designed plan.

**Depositing Employer Contributions**

Employer contributions can be made on either a calendar year basis or a fiscal year basis. However, they must adhere to the following rules:

- If a SEP IRA is maintained on a calendar-year basis, in order to obtain a deduction for employer contributions, they must be made to the financial institution maintaining the employees SEP IRA no later than the due date for the
employer’s tax return (including extensions) or within the calendar year for which the contribution is made ends; and

- If the SEP IRA is maintained on the employer’s taxable year that is a fiscal year, contributions must be made by the due date (including extensions) for filing the tax return for that year.

**Example:** If the business’s fiscal year (a corporate entity) ends on December 31 and it filed for the automatic 6-month extension, the company’s tax return for the year ending December 31, 2016, would be due on September 15, 2017, allowing the employer to make the initial SEP IRA contribution no later than September 15, 2017.

**IRS Form 5305-SEP**

The IRS makes available a model SEP IRA plan document for employers who want to adopt a plan with little paperwork and expense. IRS Form 5305-SEP can be used to satisfy the written arrangement requirement for a SEP IRA. The form must be used without modification or amendments. No approval of the signed Form 5305-SEP by the IRS is required, and the signed form does not need to be filed with the IRS.

A SEP IRA program based on IRS Form 5305-SEP is subject to the following conditions, as stated in the instructions to the form:

- An employer cannot use IRS Form 5305-SEP if they also have a qualified plan in operation;
- IRS Form 5305-SEP may not be used by an employer that is a member of an affiliated service group [IRC § 414(m)], a controlled group of corporations IRC § 414 (b)], or trades or businesses under common control [IRC §§ 414 (c) and 414 (o)], unless all eligible employees of all members participate in the SEP IRA;
- IRS Form 5305-SEP may not be used by an employer that uses leased employees [as described in IRC § 414 (n)]; and
- Each eligible employee must have established an Individual Retirement Arrangement (IRA).

The model form may not be used if the SEP IRA provides for elective employee contributions.

A SEP IRA prototype provided by a sponsoring financial institution, or an individually designed document, may be used in lieu of the IRS Form 5305-SEP, and must be used if any of the prerequisites to the use of IRS Form 5305-SEP are not satisfied. For example, only prototype (or individually drafted) plans can be used where an employer wishes to use a SEP IRA for a supplemental bonus plan to an existing qualified plan. The plan provisions vary among different prototypes, but in general they offer features not found in the basic Form 5305-SEP.
For SEP IRAs that are not installed in accordance with IRS Form 5305-SEP, the requirements for information to be provided to employees are more stringent, as discussed below.

**Notice To Interested Parties**

At the time a pension plan is established, ERISA § 3001(a) requires that every “interested party” be given notification. Where the SEP IRA is individually designed and therefore not eligible for the alternative methods of compliance, it will be necessary for the program administrator to furnish such notification to every interested party. An “interested party” is defined in Treas. Reg. § 1.7476-1(b)(1) to be an employee who is eligible to participate and all other present employers with the same principal place of employment.

Notification must be given not less than ten days or not more than 24 days prior to the date the document is filed with the IRS.

In the case of a SEP IRA formed by utilization of IRS Form 5305-SEP, this notification requirement will be satisfied by furnishing the participant with a copy of the completed IRS Form 5305-SEP. The form also requires the following to be furnished to all eligible employees:

- A statement that Traditional IRA other than the Traditional IRA into which employer SEP IRA contributions will be made may provide different rates of return and different terms concerning, among other things, transfers and withdrawals of funds from the IRA;
- A statement that in addition to the information provided to an employee at the time the employee becomes eligible to participate the administrator of the SEP IRA must furnish each participant, within 30 days of the effective date of any amendment to the SEP IRA, a copy of the amendment and a written explanation of its effects; and
- A statement that the administrator will give written notification to each participant of any employer contributions made under the SEP IRA to that participant’s IRA by the later of January 31 of the year following the year for which a contribution is made, or 30 days after the contribution is made.

If a master, prototype, or individually designed SEP IRA is used rather than the IRS Form 5305-SEP model, certain additional requirements are imposed with respect to information to employees. Thus, once an employee becomes eligible to participate, the employer must provide an explanation of participation requirements, an explanation of the formula for allocating employer contributions, the name of the person designated to provide any additional SEP IRA information and an explanation of the terms of the IRA to which SEP IRA contributions will be made.
Annual Reporting

Employers who have established a SEP IRA and have furnished eligible employees all of the documents and disclosures referred to above, are not required to file the annual information returns required for qualified plans on IRS Forms 5500 or 5500-EZ. However, under Title I of ERISA, this relief from the annual reporting requirements may not be available to an employer who selects, recommends, or influences its employees to choose Individual Retirement Arrangements into which contributions will be made under the SEP IRA, if those Individual Retirement Arrangements are subject to provisions that impose any limits on a participant’s ability to withdraw funds (other than restrictions imposed by the IRC that apply to all IRAs).

The trustee of each IRA (or the issuer of each IRA-annuity) is required to make annual calendar year reports on IRS Form 5498 concerning the status of the account or annuity. These reports are to include the amount of contributions made with respect to the calendar year, the amount of any rollover contributions, and the fair market value of the account as of the end of the year. The reports are required to be provided to the IRS and participants by May 31 of the following year.

Investment Vehicles

Under a SEP IRA, an employer makes contributions to any IRA annuity or account elected by the employee. SEP IRA plans are established with financial institutions qualified to serve as an IRA custodian, such as a bank, securities brokerage, savings and loan or a life insurance company. The employee may be given authority to select the investments within the IRA account, and is allowed to make trustee-to-trustee transfers in order to utilize a different custodian and different investment choices.

If the participant already owns an existing IRA, it is not necessary to establish a new IRA although, as a practical matter, most employers try to limit the number of carriers receiving such contributions by restricting the enrollment sessions to one or two providers. Even if the employer contribution is applied to one IRA, the amounts can be immediately transferred to another IRA of the employee without tax consequences.

SEP IRA Nondiscrimination Rules

Though SEP IRA rules are generally more liberal than those applicable to regular qualified retirement plans under IRC § 401(a)(4), an employer is still bound by the basic nondiscrimination rules imposed by IRC § 408(k)(3). Under IRC § 408(k)(3)(A) contributions to a SEP IRA may not discriminate in favor of HCEs and IRC § 408(k)(C) states that contributions shall be considered discriminatory unless they bear a uniform relationship to participant’s compensation that does not exceed $120,000 for 2017 (same as in 2016), as that term is defined in IRC § 414 (q) for purposes of qualified plans in general [IRC § 408 (k)(3) (A)].
Highly Compensated Employee as defined under IRC § 414 (q)(1)(B):

The IRS defines a “Highly Compensated Employee” (HCE) as an individual who:

1. Owned more than 5% of the interest in the business at any time during the year or the preceding year regardless of how much compensation that person earned or received; or

2. For the preceding year received compensation from the business of more than $120,000 in 2017 (same as in 2016), and if the employer so chooses, was in the top 20% of employees when ranked by compensation.

The maximum compensation level to which the uniform percentage may be applied is subject to the same statutory limitation under IRC § 401(a)(17). This limitation will be $270,000 for 2017 (was $265,000 in 2016).

In addition, the rules regarding top-heavy plans (as defined in IRC § 416) are also applicable to SEP IRAs. The dollar limitation under IRC § 416 (i)(1)(A)(i) concerning the definition of a key employee in a top heavy plan is $175,000 for 2017 (was $170,000 in 2016). In the case of a top-heavy plan, the employer contributions on behalf of each eligible non-key employee must be not less than the lesser of 3 percent of compensation or the highest percentage allocated to the IRA of a key employee for the year [IRC § 408 (k)(1) (B), incorporating IRC § 416 (c)(2)].

Rules concerning permitted disparity or integration with social security in determining contributions to a defined contribution qualified plan are applicable to SEP IRA plans.

Non-Forfeitable and Non-Assignable

Like any Traditional IRA, a SEP IRA must be non-forfeitable and thus provide for immediate vesting. Also, a SEP IRA must be non-assignable, non-alienable, and nontransferable by the participant (except for the tax-free rollover or IRA to IRA transfer privileges). There may be no employer-imposed limits on employee withdrawals or transfers from the SEP IRA, and contributions may not be conditioned upon the employee retaining the funds in the account for any stated period.

Employer Contributions

As mentioned above, employer contributions must be determined by a formula that is specified in the plan document for the SEP IRA program. The formula must be applied equally to all contributions on behalf of all participants. The annual contributions for each participant may be any amount based on a formula (but subject to the anti-discrimination-based limitations referred to above).
Contribution Formulas

The most common formula used is one which allocates contributions based on a percentage of each participant’s compensation, but there are several others, as described below. The actual formula that must be used is dependent upon the plan document that governs the SEP IRA. The various formulas are:

- **Pro-rata** – an allocation formula that provides eligible participants with a contribution based on the same percentage of compensation;
- **Flat Dollar** – an employer (plan sponsor) who provides a flat dollar formula in its SEP IRA plan must contribute the same dollar amount to each eligible employee; and
- **Integrated** – allows an employer (plan sponsor) to provide higher contributions for eligible participants who earn amounts over a set threshold, as long as the “permitted disparity rules” of IRC § 401(l) are satisfied. Integrated plans are also known as “Social Security-based” or “permitted disparity” plans. The permitted disparity rules allow the employer (plan sponsor) to give eligible participants who earn compensation above the “integration level” which is typically the Social Security taxable wage base of $127,200 in 2017 (up from $118,500 in 2016), an additional contribution. This additional contribution is equal to the lesser of:
  - Two times the base contribution percentage; or
  - The base contribution percentage plus the “permitted disparity factor;” and
  - If the employer (plan sponsor) sets the integration level at the Social Security taxable wage base, then the permitted disparity factor equals 5.7 percent.

Contribution Limits

A SEP IRA is similar to a profit-sharing plan in that the employer does not have to make a contribution to the plan each year. Contributions may vary from year to year, provided that each person covered by the plan receives the same percentage of income as a contribution.

Under IRC § 402(h)(2) it imposes a ceiling on annual employer contributions to the account of a participant in a SEP IRA. This limit is the lesser of:

- 25 percent of the compensation (within the meaning of IRC § 414(s)) from such employer includable in the employee’s gross income for the year (determined without regard to the employer contributions to the SEP IRA [IRC § 402(h)(2)(A)]; or
- A statutory dollar amount ceiling (incorporating the same inflation-adjusted dollar amount ceiling as applies, under IRC § 415 (c)(1)(A), to defined contribution plans generally, but reduced in certain cases of highly compensated employees (as discussed above). The applicable dollar amount for 2017 is $54,000 (same as in 2016).
It is the employer’s obligation to forward contributions to the financial institution (custodian/trustee) for those employees who participate as described in the plan document. The employer should keep their financial institution aware of any changes in the status of those employees in the plan. As the employer hires new employees, for instance, the employer will include them in the SEP IRA if they satisfy the eligibility criteria described in the plan.

**Contribution Limits for Self-Employed**

The contribution limit to a SEP IRA for a self-employed individual is calculated a bit differently.

*Example:* Joe, a Schedule C sole proprietor, will have $100,000 net profit on his 2017 Schedule C (after deducting all Schedule C expenses, including a 10% retirement plan contribution made for his common-law employees but not his own contribution). Joe must pay $14,130 in self employment (SE) taxes (SECA is $11,451 and Medicare is $2,678).

To compute his plan compensation, Joe must subtract from his net profit of $100,000:

- The IRC § 164(f) deduction, which in this case is ½ of his SE tax ($14,130 x ½); and
- The amount of contribution for himself to the plan.

To determine the amount of his plan contribution, Joe must use the reduced plan contribution rate (considering the plan contribution rate of 10%) of 9.0909% from the rate table in IRS Pub 560 (see Table 3.1).

**Table 3.1**
*Rate Table for Self-Employed*

<table>
<thead>
<tr>
<th>Column A If the plan contribution rate is shown as %</th>
<th>Column B Your rate is shown as decimal</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.009901</td>
</tr>
<tr>
<td>2</td>
<td>.019608</td>
</tr>
<tr>
<td>3</td>
<td>.029126</td>
</tr>
<tr>
<td>4</td>
<td>.038462</td>
</tr>
<tr>
<td>5</td>
<td>.047619</td>
</tr>
<tr>
<td>6</td>
<td>.056604</td>
</tr>
<tr>
<td>7</td>
<td>.065421</td>
</tr>
<tr>
<td>8</td>
<td>.074074</td>
</tr>
<tr>
<td>9</td>
<td>.082569</td>
</tr>
<tr>
<td>10</td>
<td>.090909</td>
</tr>
<tr>
<td>11</td>
<td>.099099</td>
</tr>
<tr>
<td>12</td>
<td>.107143</td>
</tr>
<tr>
<td>13</td>
<td>.115044</td>
</tr>
<tr>
<td>14</td>
<td>.122807</td>
</tr>
</tbody>
</table>
Alternatively, Joe can compute his reduced plan contribution rate by:

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Taking the plan contribution rate</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 2</td>
<td>Dividing the plan contribution rate by 100% + plan contribution rate</td>
<td>10% / 110%</td>
</tr>
<tr>
<td>Step 3</td>
<td>To get the reduced plan contribution rate</td>
<td>9.0909%</td>
</tr>
</tbody>
</table>

Joe can now compute his own contribution/deduction amount as follows:

<table>
<thead>
<tr>
<th>Step 1</th>
<th>$100,000</th>
<th>Schedule C net profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 2</td>
<td>$7,065</td>
<td>½ SE tax deduction ($14,130 x ½)</td>
</tr>
<tr>
<td>Step 3</td>
<td>$92,935</td>
<td>Net profit reduced by ½ SE tax</td>
</tr>
<tr>
<td>Step 4</td>
<td>$9,0909%</td>
<td>Joe’s reduced plan contribution rate</td>
</tr>
<tr>
<td>Step 5</td>
<td>$8,449</td>
<td>Joe’s allowed contribution and deduction</td>
</tr>
</tbody>
</table>

There is a simple way to quickly verify the accuracy of Joe’s contribution/deduction amount:

<table>
<thead>
<tr>
<th>1</th>
<th>$100,000</th>
<th>Joe's Schedule C net profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$7,065</td>
<td>½ SE tax deduction</td>
</tr>
<tr>
<td>3</td>
<td>$8,449</td>
<td>Joe's contribution/deduction for himself</td>
</tr>
<tr>
<td>4</td>
<td>$84,486</td>
<td>Amount subject to plan's full rate</td>
</tr>
<tr>
<td>5</td>
<td>10%</td>
<td>Plan's full rate</td>
</tr>
<tr>
<td>6</td>
<td>$8,449</td>
<td>Joe's contribution/deduction for himself</td>
</tr>
</tbody>
</table>

If lines 3 and 6 above match, the contribution/deduction calculation is correct.
Excess Contribution Rule

Any amount contributed on behalf of an employee in excess of the applicable limitation is treated as an excess contribution. As such, the excess amount is treated as taxable compensation to the employee, followed by a contribution by the employee to the account [IRC § 402 (h)]. As was discussed in Chapter 2, in the case of excess IRA contributions, generally the excess amount is subject to a 6 percent excise (penalty) tax, unless the excess amount, together with income allocable thereto, is withdrawn on or before the due date (including extensions) for filing the income tax return for the year with respect to which the excess contributions were made. The 6 percent excise tax is again imposed for the following year unless the excess amount is withdrawn before the due date for that year’s return. Alternatively, it can be applied as part or all of the maximum allowable contribution for such following year [IRC § 4973 (a) and (b)]. Any portion of such excess not fully withdrawn or applied against the maximum allowable contribution for the year following the year of the excess contribution will incur the 6% tax every succeeding year. When an excess contribution is withdrawn, the entire amount withdrawn is income taxable to the employee.

More Than One Employer

In cases where an employee works for two or more unrelated employers and only one employer has a SEP IRA, only the compensation paid by the SEP IRA employer is used to calculate the maximum SEP IRA contribution. If both employers have SEP IRA’s, the contribution limitation applies separately to each SEP IRA. Self-employed individuals (sole proprietors and partners) who are involved in more than one business are treated as being employed by a single employer, thus limiting their annual contribution to a SEP IRA to 25 percent of compensation or the applicable dollar ceiling.

Multiple Plans

Employers can maintain a SEP IRA as well as another qualified retirement plan. In such situations, the employer cannot use the IRS model forms discussed earlier. Additionally, the SEP IRA will be treated as a defined contribution plan, subject to the annual contribution limit of the lesser of:

- The SEP IRA limit; or
- The DC plan limit applied to the SEP IRA and the other plan(s) in the aggregate.

Deduction by the Employer

In general, employer contributions falling within the limitations discussed above are deductible by the employer, and are non-taxable to the employee. SEP IRA contributions are not reported on an employee’s W-2 form so employees do not need to take a Traditional IRA deduction for SEP IRA contributions to their account.
Excess contributions are deductible in succeeding years, to the extent that the carryover amount, together with the contributions for the carryover year, does not exceed the applicable limit for the carryover year [IRC § 404 (h)(1)(C)].

The employer may deduct the contributions for the taxable year to which they relate, even if made after the close of the year, as long as they are made no later than the due date (including extensions) for filing of the tax return for the year [IRC § 404 (h)(1)].

**SARSEP IRA Plans**

SARSEP IRA is a SEP IRA that includes a salary reduction arrangement, under this type of arrangement, the employee can elect to contribute part of his or her pay to the SEP. The *Small Business Job Protection Act* (SBJPA) of 1996 prospectively repealed SARSEPs. No new SARSEPs can be established after December 31, 1996. However, employers that established SARSEPs prior to January 1, 1997, can continue to maintain them, and new employees of the employer hired after December 31, 1996 can participate in the existing SARSEP. SARSEPs are defined under IRC § 408(k)(6).

**Note:** One of the eligibility rules for the SARSEP IRA was that the number of employees could not exceed 25. If an existing SARSEP IRA has more than 25 employees it must become a SEP IRA.

**Contributions to SARSEP IRA**

A SARSEP IRA permits an employee to elect to have the employer either:

- Make elective employer contributions to the SARSEP IRA on behalf of the employee; or
- Distribute an amount in cash to the employee.

If the employee takes cash, the distribution is includable in the employee’s income. If the employee chooses salary reduction, the employee excludes the amount of the salary reduction contribution from income for the year of contribution. However, salary reduction contributions to a SARSEP IRA are subject to payroll (FICA and FUTA) taxes [IRC §§ 3121(a)(5)(C) & 3306(b)(5)(C)]. If the employee chooses salary reduction, taxation is generally deferred until distributions are made from the SARSEP IRA. Thus, salary reduction is a form of elective deferral.

Salary reduction contributions to a SARSEP IRA, as well as all other elective deferrals to retirement plans, are subject to a combined overall limitation for elective deferrals in a year [IRC § 402(h)(2)].

The most a participant can choose to defer for calendar year 2017 is the lesser of the following amounts:
• 25% of the participant’s compensation limited to $270,000 of the participant’s compensation (same as in 2016); or
• $18,000 (same as in 2016).

The salary reduction limit applies to the total elective deferrals the employee makes for the year to a SEP IRA and any of the following:

• Cash or deferred arrangement (401(k) plan);
• Salary reduction arrangement under a TSA (403(b) plan); and
• SIMPLE IRA.

A SARSEP IRA can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contributions limit in 2017 is $6,000 (same as in 2016). Elective deferrals are not treated as catch-up contributions until they exceed the elective deferral limit or the plan limit.
Chapter 3
Review Questions

1. A SEP IRA is defined and governed by which Section of the Internal Revenue Code (IRC)?
   ( ) A. IRC § 408 (k)
   ( ) B. IRC § 408A
   ( ) C. IRC § 457(b)
   ( ) D. IRC § 403 (b)

2. Which of the following statements about SEP IRA contributions is FALSE?
   ( ) A. SEP IRA is established and maintained solely by the employee but to which his or her employer makes the contribution.
   ( ) B. Employer contributions can be made on either a calendar year basis or a fiscal year basis.
   ( ) C. Employer contributions are required every year.
   ( ) D. Employer contributions must be determined by a formula that is specified in the plan document.

3. Under IRC § 402(h)(2) what is maximum annual employer contribution to the account of a participant in a SEP IRA in 2017?
   ( ) A. Lesser of 25% of compensation or $54,000
   ( ) B. Lesser of 25% of compensation or $18,000
   ( ) C. Lesser of 100% of compensation or $53,000
   ( ) D. Lesser of 100% of compensation or $18,000

4. Which of the following is the most common formula used for SEP IRA contributions?
   ( ) A. Flat Dollar
   ( ) B. Integrated
   ( ) C. Increasing percentage
   ( ) D. Percentage of each participant’s compensation

5. To maintain a SARSEP IRA after 1997, what is the maximum number of participating employees allowed?
   ( ) A. 25
   ( ) B. 10
   ( ) C. 50
   ( ) D. 100
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CHAPTER 4

SIMPLE IRA

Overview

The passage of the Small Business Job Protection Act of 1996 created a new Individual Retirement Arrangement (IRA), known as the Savings Incentive Match Plan (SIMPLE) IRA. The SIMPLE IRA is designed to help employees working for smaller businesses save for retirement on a tax-favored basis, while allowing employers current-year tax deductions. As part of the inducement to attract employers to adopt a SIMPLE IRA, many of the complex rules applicable to traditional qualified plans, such as top-heavy rules and nondiscrimination tests, were eliminated.

This chapter will review the rules and regulations under IRC§ 408(p), which governs the SIMPLE IRA.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Review the legislative intent of the SIMPLE IRA;
- Define a SIMPLE IRA;
- Identify eligible employers;
- Utilize IRS forms to structure a SIMPLE IRA;
- Outline eligibility and contribution rules for employers and employees; and
- Determine taxpayer qualifications and amounts for the Savers Tax Credit.

SIMPLE IRA Defined

A SIMPLE IRA is a retirement plan that can take the form of either an Individual Retirement Arrangement (IRA), called a SIMPLE IRA, or a cash or deferred arrangement called a SIMPLE 401(k) plan. With a SIMPLE IRA, an employee makes a contribution to his or her individual account through salary reduction and the employer transfers this amount to the employee’s account. The employer, in return, is required to make an annual contribution to each participating employee’s account. The contribution is then deposited into a trust account for the employee where it grows tax-free until distributed.

Only those employers that meet the specific eligibility requirements discussed below may establish a SIMPLE IRA.
Employer Eligibility

Only an eligible employer may adopt a SIMPLE IRA plan. An “eligible employer” is defined as an employer who employs no more than 100 employees earning at least $5,000 during the preceding year [IRC § 408(p)(2)(C)(i)]. In determining the number of employees for this purpose, the employer must meet the following:

- Employees who earned less than $5,000 are not counted, but employees who are excluded from participation (e.g., union employees and nonresident aliens) must be counted [IRC § 408 (p)(2)(C)(i)]. The term “employer” includes related employers (such as trades or businesses under common control, whether incorporated or not), controlled groups of corporations and affiliated service groups. For example, a business employing 80 eligible employees cannot establish a SIMPLE IRA if it has a subsidiary with more than 20 eligible employees; and
- An employer cannot create a SIMPLE IRA if it already maintains (or has maintained in the same year) another SIMPLE IRA plan or other qualified plan. A qualified plan includes a qualified retirement plan, qualified annuity plan, a government plan, tax-sheltered annuity or simplified employee pension (SEP IRA) [IRC §§ 408 (p)(2)(D); 219 (g)(5)].

Employee Eligibility

A SIMPLE IRA plan must be open to every employee who:

- Received at least $5,000 in compensation from the employer during any two preceding years; and
- Is expected to receive at least $5,000 in compensation during the current year.

However, an employer can exclude:

- Nonresident alien employees who receive no U.S. source income;
- Employees covered under a collective bargaining agreement (whose retirement benefits were the subject of good-faith bargaining) from participating in the plan; and
- Certain employees not covered by collective bargaining agreements covering airline pilots [IRC § 408(p)(4)].

An employer may impose less restrictive eligibility requirements by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both, under its SIMPLE IRA.

Example: An employer could allow participation for employees who received $3,000 in compensation during any preceding calendar year. However, the employer cannot impose any other conditions on participating in a SIMPLE IRA [Notice 98-4, 1998-2 I.R.B. 26, Q & A C-2].
Establishing a SIMPLE IRA Plan

An eligible employer must take the following three steps to set up a SIMPLE IRA Plan:

- **Step 1:** Adopt a SIMPLE IRA plan document by signing one of these documents:
  - IRS Model SIMPLE IRA plan using either:
    - IRS Model 5305 SIMPLE IRA (if you require all contributions to be deposited initially at a designated financial institution); or
    - Form 5304-SIMPLE (if you permit each employee to choose the financial institution for receiving contributions).
  - IRA-approved prototype SIMPLE IRA plan offered by banks, insurance companies and other qualified financial institutions.

- **Step 2:** Provide each eligible employee (discussed below) with certain information about the SIMPLE IRA plan and SIMPLE IRA where the employer will deposit employee contributions prior to the employee election period (generally 60 days prior to January 1).

- **Step 3:** Set up a SIMPLE IRA for each eligible employee using either IRS Model:
  - Form 5305-S: a trust account; or
  - Form 5305-SA: a custodial account.

**Deadline to Set-up a SIMPLE IRA**

A SIMPLE IRA plan can be set up effective on any date between January 1 and October 1, provided the employer (or any predecessor employer) didn’t previously maintain a SIMPLE IRA plan. If a new employer that came into existence after October 1 of the year, the new employer can establish the SIMPLE IRA plan as soon as administratively feasible after the business came into existence. If an employer had previously established a SIMPLE IRA plan, the employer must set up a new one effective on January 1. The effective date cannot be before the employer actually establishes the plan.

**Note:** A SIMPLE IRA plan may only be maintained on a calendar-year basis.

**Two-Year Grace Period**

An employer can initially employ fewer than 100 employees but cannot exceed this number over time. In such cases, the employer can continue the SIMPLE IRA for two years after the last year it met the eligibility requirements. At the end of this two-year grace period, the employer must discontinue the SIMPLE IRA plan.
Required Enrollment Periods

An eligible employee must be given the right to enter into a salary reduction agreement during the “60-day period” immediately preceding January 1 of a calendar year (that is, November 2 to December 31 of the preceding calendar year). An eligible employee also must be given the right to enter into a salary reduction agreement for the calendar year or to modify a prior agreement (including reducing the amount to $0 subject to this agreement). However, for the year in which the employee first becomes eligible to make salary reduction contributions, the period during which the employee may enter into a salary reduction agreement or modify a prior agreement is the 60-day period that includes either the date the employee becomes eligible or the day before that date.

Example 1: On November 1, 2016, The Filter Company decides to establish its first retirement plan. It adopts a SIMPLE IRA plan with no service or compensation requirements for its 40 employees. The plan is duly adopted and effective on January 1, 2017. Eligible employees are given a completed summary description, a model notification and a model salary reduction agreement on November 1, 2016. The 60-day period starts on November 2 and ends on December 31, 2017. Here, the 60-day period includes December 31, the “day before” the date the employee becomes eligible (January 1). Although contributions can be discontinued at any time, no modifications are permitted after the 60-day election period unless the plan provides for additional opportunities to modify (or make) an election to defer compensation.

Example 2: An employer establishes a SIMPLE IRA plan effective July 1, 2017. Each eligible employee becomes eligible to make salary reduction contributions on that date, and the 60-day period must begin no later than July 1 and cannot end before June 30, 2017.

The 60-day election period is the 60-day period before the beginning of any year (and the 60-day period before first becoming eligible to participate). In general, this is the statutory period during which an eligible employee may elect to participate or modify a previous election amount. The employer may allow additional periods for making and changing elections. Thus, for a calendar year, an eligible employee may make or modify a salary reduction election during the 60-day period immediately preceding January 1 of that year. However, for the year in which the employee first becomes eligible to make salary reduction contributions, the period during which the employee may make or modify the election is a 60-day period that includes either the date the employee becomes eligible or the day before. In addition, the plan can provide for additional periods during which an employee may make a salary reduction election or modify a prior election.

During the 60-day period, an employee may modify his/her salary reduction agreements without restrictions. In addition, for the year in which an employee becomes eligible to make salary reduction contributions, he/she must be able to commence these contributions as soon as he/she becomes eligible, regardless of whether the 60-day period has ended.
An employee who commences participation during the election period may cancel or modify a previous election. Any such change is prospective and should be implemented by the employer as soon as possible or in accordance with the documentation submitted to the employer. Nothing precludes a SIMPLE IRA plan from providing additional or longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements.

Note: An employer may set up a SIMPLE IRA with automatic enrollment. A plan feature allowing an employer to automatically deduct a fixed percentage or amount from an employee’s wages and contribute that to the SIMPLE IRA plan unless the employee has affirmatively chosen to contribute nothing or to contribute a different amount. These automatic enrollment contributions qualify as elective deferrals.

SIMPLE IRA Contributions

If an employer establishes a SIMPLE IRA it must make salary reduction contributions, to the extent elected by employees, and must make employer matching contributions or employer non-elective contributions, all as described below. These are the only contributions that may be made under a SIMPLE IRA. The following rules regarding contributions are set forth in Notice 98-4, 1998-2 I.R.B. 26, Q&As D1-D6, and in IRC §14(v).

Employee Salary Reduction Contributions

A salary reduction contribution is a contribution made pursuant to an employee’s election to have an amount contributed to his or her SIMPLE IRA, rather than have the amount paid directly to the employee in cash. An employee must be permitted to elect to have salary reduction contributions made at the level specified by the employee, expressed as a percentage of compensation for the year or as a specific dollar amount. An employer may not place any restrictions on the amount of an employee’s salary reduction contributions (e.g., by limiting the contribution percentage), except to the extent needed to comply with the IRC’s annual limit on the amount of salary reduction contributions.

An employee’s annual salary reduction contribution to a SIMPLE IRA is subject to a maximum dollar limitation, in accordance with the following schedule [IRC § 408 (p)(2) (E)]. Table 4.1 shows the SIMPLE employee salary reduction for 2016 and 2017. For 2017, the annual salary reduction contribution is $12,500 (same as in 2016).

Table 4.1
SIMPLE IRA Employee Salary Reduction
(Elective Deferrals)

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Annual Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$12,500</td>
</tr>
<tr>
<td>2017</td>
<td>$12,500</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590
Catch-Up Provision for Older Participants

Effective since 2002, older participants were allowed to “catch up” with respect to adequate funding of their retirement, the otherwise applicable dollar limit (see Table 4.1) on elective deferrals under a SIMPLE IRA was increased for individuals who have attained the age of 50 by the end of the year [IRC § 414 (v)(2)(B)(ii)]. The catch-up contribution does not apply to after-tax employee contributions. Additional contributions may be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of any limitation of the IRC (e.g., the annual limit on elective deferrals) or of the plan. Table 4.2 shows the additional amount of elective catch-up contributions that may be made by an eligible employee (participant) age 50 and older. For 2017, the catch-up contribution for a SIMPLE IRA is $3,000 (same as in 2016).

Table 4.2
SIMPLE IRA
Catch Up Contribution Amount

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Annual Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$3,000</td>
</tr>
<tr>
<td>2017</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590

The $3,000 amount was adjusted for inflation in $500 increments beginning in 2007 and thereafter, using the third calendar quarter of 2005 as the base period. The supplemental catch-up contribution is not allowed to the extent that it would result in total elective deferrals for the year exceeding the participant’s compensation for the year. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, such contributions are not subject to applicable nondiscrimination rules. However, a plan fails to meet the applicable nondiscrimination requirements under IRC § 401(a)(4) with respect to benefits, rights and features unless the plan allows all eligible individuals participating in the plan to make the same election with respect to catch-up contributions. For purposes of this rule, all plans of related employers are treated as a single plan.

Employer Matching Contributions

Under a SIMPLE IRA, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee’s salary reduction contributions, up to a limit of 3 percent of the employee’s compensation for the entire calendar year. The 3 percent limit on matching contributions is permitted to be reduced for a calendar year at the election of the employer, but only if:

- The limit is not reduced below 1 percent;
• The limit is not reduced for more than 2 years out of the 5-year period that ends with (and includes) the year for which the election is effective; and
• Employees are notified of the reduced limit within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements.

For purposes of applying the foregoing rule, in determining whether the limit was reduced below 3 percent for a year, any year before the first year in which an employer (or a predecessor employer) maintains a SIMPLE IRA will be treated as a year for which the limit was 3 percent. If an employer chooses to make non-elective contributions (discussed below) for a year, that year also will be treated as a year for which the limit was 3 percent.

**Employer Non-elective Contributions**

As an alternative to making matching contributions under a SIMPLE IRA, an employer may make non-elective contributions equal to 2 percent of each eligible employee’s compensation for the entire calendar year. The employer’s non-elective contributions must be made for each eligible employee regardless of whether the employee elects to make salary reduction contributions for the calendar year. The employer may, but is not required to, limit non-elective contributions to eligible employees who have at least $5,000 (or some lower amount selected by the employer) of compensation for the year. For purposes of the 2-percent non-elective contribution, the compensation taken into account must be limited to the amount of compensation that may be taken into account under IRC § 401(a)(17) for the year.

The IRC § 401(a)(17) limit for 2017 is $270,000 (was $265,000 in 2016). So, the maximum total contribution allowed for employer non-elective contributions in 2017 is $5,400 (.02% x $270,000).

An employer may substitute the 2 percent non-elective contribution for the matching contribution for a year, only if:

• Eligible employees are notified that a 2 percent non-elective contribution will be made instead of a matching contribution; and
• This notice is provided within a reasonable period of time before the 60 day election period during which employees can enter into salary reduction agreements.

**Tax Consequences of Contributions**

Contributions to a SIMPLE IRA are excludable by the employee from federal income tax, and not subject to federal income tax withholding. Salary reduction contributions to a SIMPLE IRA are subject to tax under the *Federal Insurance Contributions Act* (“FICA”), the *Federal Unemployment Tax Act* (“FUTA”), and the Railroad Retirement
Act (“RRTA”), and must be reported on Form W-2, Wage and Tax Statement. Matching and non-elective contributions to a SIMPLE IRA are not subject to FICA, FUTA, or RRTA taxes, and are not required to be reported on Form W-2 [Notice 98-4, 1998-2 I.R.B. 26, Q&A I-1].

Pursuant to IRC § 404(m), contributions under a SIMPLE IRA are deductible in the taxable year of the employer with or within which the calendar year for which contributions were made ends (without regard to the limitations of IRC § 404(a)).

Example: If an employer has a June 30 taxable year-end, contributions under the SIMPLE IRA for the calendar year 2017 (including contributions made in 2016 before June 30, 2016) are deductible in the taxable year ending June 30, 2017. Contributions will be treated as made for a particular taxable year if they are made on account of that taxable year and are made by the due date (including extensions) for filing the return for the taxable year [Notice 98-4, 1998-2 IRB 26, Q&A I-7].

Vesting Requirements

All contributions under a SIMPLE IRA must be fully vested and non-forfeitable when made. An employer may not require an employee to retain any portion of the contributions in his or her SIMPLE IRA or otherwise impose any withdrawal restrictions [Notice 98-4, 1998-2 I.R.B. 26, Q &As F-1 & F-2].

Distribution Rules

Distributions from SIMPLE IRAs are subject to the regular distribution tax rules of a Traditional IRA (see Chapter 6 and 7). However, during the first two (2) years of the plan, if the participant withdraws money from the plan, he/she will be subject to a 25 percent penalty on the money taken from the fund in addition to taxes owed [IRC § 408(d)(3)(g)].

New SIMPLE IRA Rollover Rules

The Consolidated Appropriations Act that became law on December 18, 2015 allows a participant in a qualified retirement plan, IRC § 403(b) plan, or IRC § 457 plan to roll over their distribution from that plan to a SIMPLE IRA account.

Prior to this change, a SIMPLE IRA could only accept contributions under a qualified salary reduction arrangement (i.e., another SIMPLE IRA plan). The change applies only to rollovers after the two year period beginning on the date a participant in such an employer plan first participated in the SIMPLE plan sponsored by their employer. The employer will have to verify that the two year period has been satisfied before permitting the rollover.
Saver’s Tax Credit

As part of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, Congress enacted a temporary tax credit to encourage retirement savings by low and middle income individuals when they invest in an IRA, 403(b), 457 and/or 401(k) plan. The non-refundable credit, which was supposed to sunset in 2011, has been made permanent with the PPA of 2006.

Under IRC § 25B(1), the Saver’s Tax Credit is a non-refundable income tax credit that could reduce the taxpayer’s federal income tax liability to $0. However, there is a catch. Depending on the individual’s adjusted gross income (reported on Form 1040 or 1040A), the amount of the credit is 50%, 20% or 10% of the retirement plan or IRA contributions up to $2,000 ($4,000 if married filing jointly). Table 4.3 shows the requirements for 2016 and Table 4.4 shows the requirements for 2017.

Table 4.3
Saver’s Tax Credit Filing Status/MAGI Income for 2016

<table>
<thead>
<tr>
<th>Credit Rate</th>
<th>MFJ</th>
<th>HHLD</th>
<th>Single/Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% of your contribution</td>
<td>$0 to $37,000</td>
<td>$0 to $27,750</td>
<td>$0 to $18,500</td>
</tr>
<tr>
<td>20% of your contribution</td>
<td>$37,001 to $40,000</td>
<td>$27,751 to $30,000</td>
<td>$18,501 to $20,000</td>
</tr>
<tr>
<td>10% of your contribution</td>
<td>$40,001 to $61,500</td>
<td>$30,001 to $46,125</td>
<td>$20,001 to $30,750</td>
</tr>
<tr>
<td>0% of your contribution</td>
<td>More than $61,500</td>
<td>More than $46,125</td>
<td>More than $30,750</td>
</tr>
</tbody>
</table>

Table 4.4
Saver’s Tax Credit Filing Status/MAGI Income for 2017

<table>
<thead>
<tr>
<th>Credit Rate</th>
<th>MFJ</th>
<th>HHLD</th>
<th>Single/Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% of your contribution</td>
<td>$0 to $37,000</td>
<td>$0 to $27,750</td>
<td>$0 to $18,500</td>
</tr>
<tr>
<td>20% of your contribution</td>
<td>$37,001 to $40,000</td>
<td>$27,751 to $30,000</td>
<td>$18,501 to $20,000</td>
</tr>
<tr>
<td>10% of your contribution</td>
<td>$40,001 to $62,000</td>
<td>$30,001 to $46,500</td>
<td>$20,001 to $31,000</td>
</tr>
<tr>
<td>0% of your contribution</td>
<td>More than $62,000</td>
<td>More than $46,500</td>
<td>More than $31,000</td>
</tr>
</tbody>
</table>

Source: IRS Announces Pension Plan Limitations for 2017 and 2016, October 2016

To claim the credit, the taxpayer must use IRS Form 8880 together with their 1040.
Chapter 4
Review Questions

1. Which Section of the Internal Revenue Code (IRC) governs the SIMPLE IRA?
   ( ) A. IRC § 401(k)
   ( ) B. IRC § 401(a)
   ( ) C. IRC § 457(b)
   ( ) D. IRC § 408(p)

2. An “eligible employer” is defined as an employer who employed no more than 100 employees earning at least what amount from the employer during the preceding year?
   ( ) A. $5,000
   ( ) B. $600
   ( ) C. $2,500
   ( ) D. $5,500

3. What is the tax penalty for a distribution from a SIMPLE IRA within the first two years?
   ( ) A. 50%
   ( ) B. 6%
   ( ) C. 10%
   ( ) D. 25%

4. What is the maximum catch-up contribution for a SIMPLE IRA in 2017?
   ( ) A. $5,000
   ( ) B. $3,000
   ( ) C. $1,000
   ( ) D. $500

5. Which of the following IRS Forms must be filed by a taxpayer to claim the Saver’s Tax Credit?
   ( ) A. IRS Form 8880
   ( ) B. IRS Form 8608
   ( ) C. IRS Form 5329
   ( ) D. IRS Form 5498
IRA ROLLOVERS

Overview

With the enactment of *The Employment Retirement Income Security Act* (ERISA) of 1974 a new concept was introduced called “*rollovers*” governed under IRC § 402(c). Prior to the enactment of ERISA, the Internal Revenue Service (IRS) routinely allowed the tax-free direct transfer of retirement funds from one retirement plan to another. The most important concept to remember about direct transfers is that no distribution of retirement funds are made to the participant. The funds are transferred directly to a successor trustee or custodian.

In this chapter, we will examine the purpose of IRA rollovers, define the differences between an indirect and a direct rollover, and review several pieces of legislation that have made some significant changes to the tax law pertaining to rollovers. In addition, at the end of the chapter we will discuss the role of the DOL’s Conflict of Interest Rule and how it will affect IRA rollovers.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Define the purpose of IRA rollovers;
- Explain Indirect and Direct IRA rollovers;
- Review the various tax laws and reporting requirements for IRA rollovers;
- Present the various types of IRA rollovers; and
- Demonstrate an understanding of the DOLs Conflict of Interest Rule when recommending a rollover to a retirement client.

Purpose of IRA Rollovers

IRA rollovers are the second way that funds may be contributed (transferred) to an IRA. As important as IRAs have been in providing a tax-deferred contribution-based retirement savings program for workers not covered by employer-sponsored retirement plans (ESRP), they also have been extremely valuable as a way for workers to preserve qualified retirement plan assets upon the following events:
• Job changers, layoff or terminations;
• Retirement; and
• In service distributions.

Generally, when a participant receives a distribution from an IRA, it is generally reported as income and taxes must be paid in the tax year of the distribution. Also, participants who take a distribution prior to age 59½ normally will also have to pay the 10 percent tax penalty for premature distribution.

The rollover provisions under IRC § 402(c), allow the participant to completely avoid these income and tax penalty consequences. The participant can receive a distribution from an IRA if it is rolled over to the same or different retirement plan or IRA and meets various requirements (discussed below). Once the distribution is rolled over the amounts are then generally subject to the rules of the plan to which rolled over.

There are two basic types of IRA rollovers:

• Indirect rollover; and
• Direct (trustee-to-trustee) rollover

**In Direct Rollovers**

When we refer to an “Indirect” IRA-to-IRA rollover, we are talking about the situation where a distribution of assets from one IRA passes through the hands (in-hand distribution) of the IRA participant and then back into the same or another IRA.

This type of rollover is conditionally permitted between IRA custodial accounts and annuity contracts and qualified retirement plans. However, there are some very important eligibility requirements that must be met in order to maintain the tax-deferral of the funds distributed.

**60 Day Eligibility Rule**

IRC § 408(d)(3)(A) requires that distributions received from an IRA must be re-deposited back into the IRA no later than the 60th day after the date the distribution is received to avoid IRC § 408(d)(1) taxable distribution treatment.

A rollover must generally be completed no later than “the 60th day following the day on which the participant received the property distributed.” There is no automatic extension of this deadline if it falls on a weekend or holiday. The deadline is 60 days, not two months.

**Example:** A distribution made on March 12th must be rolled over by May 11th, May 12th is too late.
Tax Consequences for Not Meeting the 60-day Rule

If a participant (IRA owner) failed to roll over a distribution within the 60-day period and doesn't qualify for an exception, he/she must include any taxable amount of the distribution as income, and pay the applicable taxes.

These tax consequences can be serious. If the funds are not returned within 60 days, the withdrawal will not only be treated as a taxable distribution for participants who are under the age of 59 ½, but the participant will also face an additional 10 percent penalty tax, as well as possible state income tax.

Note: If a participant decides to take the short-term, 60 day “loan” from an IRA he/she must report the entire amount of the withdrawal. The withdrawal is reported on line 15a of the participants’ Form 1040 for the tax year in which he/she took the withdrawal. If the participant had returned the withdrawn funds within the 60 day period, he/she will enter “zero” as the taxable amount of line 15b of Form 1040.

Waiver of 60 Day Rule

However, IRC § 408(d)(3)(I) allows the IRS to waive, by private letter ruling (PLR), the 60 day requirement where failure to do so would be “against equity or good conscience.” Revenue Procedure 2003-16 states that, in determining whether to grant the waiver, all relevant facts and circumstances are to be considered, including:

- Errors of the financial institution;
- Inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error;
- The use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and
- The time elapsed since the distribution occurred.

For many years, the user fee for this type of ruling was based on the size of the rollover:

- Rollover of less than $50,000, the fee was $500
- Rollover of $50,000 to $100,000, the fee was $1,500
- Rollover of $100,000 or more, the fee was $3,000

IRS Revenue Procedure 2016-8 made some changes to the above fee schedule, to be effective February 2, 2016. The new user fee for 60-day hardship Private Letter Rulings (PLRs) will be the standard fee of $10,000, which is a significant increase.

Note: Requesting a PLR can be a costly and time-consuming process and often requires the assistance of an attorney or accountant. A taxpayer should consult with their tax and/or legal professional for guidance on requesting a PLR. You can visit the following IRS website to get more information on the PLR process; https://www.irs.gov/irb/2016-01_IRB/ar10.html
Exceptions to the 60-day Rule

The IRS allows a few exceptions to the 60-day rule. Using them can help the participant avoid paying taxes on rollover-eligible distributions that do not satisfy the 60-day rule, and ensure continued tax-deferred growth on their retirement assets. The exceptions are:

- **First-Time Homebuyers.** Taxable distributions of up to $10,000 from a participant’s IRAs is not subject to the 10% additional tax (early-distribution penalty) if the participant (IRA owner) or a qualified family member is a first-time homebuyer and, within 120 days of receipt, the participant uses the amount to pay for qualifying acquisition or rebuilding costs for his/her own or qualifying family member's principal residence. If the amount is not used because of a cancellation or delay in the purchase or construction of the residence, the amount may be rolled over to the IRA within 120 days instead of the usual 60 days.

- **Automatic Waiver for Hardship.** A participant may deliver distributed assets to a financial institution and intend the amount be deposited to his/her retirement account as a rollover contribution. Sometimes, because of an error, the amount is not credited to the retirement account within the 60-day period. Such errors can occur if a participant maintains multiple accounts with his/her financial institution and a representative inadvertently deposits the amount to the wrong account. If this occurs the participant may be eligible to receive an automatic extension of the 60-day period, providing all of the following requirements are met:
  - The assets were delivered to the financial institution within 60 days after the participant had received the distribution;
  - The participant followed the procedural requirements for rollover contributions that were established by his/her financial institution;
  - The amount was not deposited to the participants’ retirement account because of an error made by the financial institution;
  - The assets are deposited to the participants’ retirement account within one year after he/she received the distribution; or
  - The transaction clearly would have been a valid rollover contribution had the financial institution followed the participants’ instructions at the time of receipt.

- **Non-Automatic Waiver Application.** If a participant is unable to complete his/her rollover contribution because of certain circumstances beyond their reasonable control, the participant can submit an application to the IRS for a waiver or extension of the 60-day rule. When reviewing the application, the IRS determines whether the participant meets certain requirements by considering the following:
  - Whether any mistakes were made by a financial institution, other than those described in the above section "Automatic Waiver for Hardship;"
  - Whether the inability to complete the rollover was the result of death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or a postal error;
  - How the distributed amount was used. For instance, if the participant received a check for the distributed amount, the IRS will want to know whether the check was cashed; and
How long it has been since the distribution occurred.

Additionally, the IRS will look at whether the participant had any intention of rolling over the distributed amount at the time the withdrawal occurred. If the IRS determines that the participant didn't have this intention, his/her request for waiver may not be approved. Also, before applying for a waiver of the 60-day rule, check to make sure the amount in question is rollover eligible. For instance, if the distribution occurred from an IRA from which another distribution was rolled over during the 12 months preceding the distribution in question, this second distribution is not rollover eligible.

In order to be considered for the waiver, the participant must submit an application for a private letter ruling (PLR) to the IRS and pay the applicable (“user” fee) discussed below.

After reviewing the application, the IRS will issue a PLR to the participant indicating whether his/her application is approved. If it is, it will include the time limit within which the rollover contribution must be completed. If the participants’ application is not approved and he/she already deposited the amount to their retirement account, it must be removed as a return of an excess contribution.

Note: These exceptions are not available in Inherited/Beneficiary IRAs. There are no contributions allowed in Inherited/Beneficiary IRAs so there is no ability for a 60-day rollover into these accounts.

IRS Rev. Proc. 2016-47: Self Certification for Late Rollovers

In Rev. Proc. 2016-47, the IRS announced that a participant who fails to meet the requirement to roll over distributions from retirement accounts within the normal 60-day period can make a written self-certification to an IRA trustee or plan administrator that a contribution meets one of the 11 specific reasons listed in the revenue procedure for excusing the missed 60-day deadline. The trustee or administrator can rely on the participant’s self-certification, subject to verification if the participant is audited. The certification must match the sample in the appendix of the revenue procedure word for word or be “substantially similar in all material respects.”

To qualify for this relief, the IRS cannot have previously denied relief to the participant for that rollover, and the participant must have missed the 60-day deadline for one of the following 11 reasons:

- The financial institution receiving the contribution or making the distribution to which the contribution relates made an error;
- The distribution check was misplaced and never cashed;
- The distribution was deposited into an account that the participant mistakenly thought was an eligible retirement plan;
- The participant’s principal residence was severely damaged;
- A member of the participant’s family died;
The participant or a member of the participant’s family was seriously ill;
- The participant was incarcerated;
- Restrictions were imposed by a foreign country;
- The post office made an error;
- The distribution was made on account of a levy under Sec. 6331, the proceeds of which have been returned to the participant; or
- The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite the participant’s reasonable efforts to obtain it.

The rollover contribution must be made to the plan or IRA as soon as practicable after the reason or reasons for missing the 60-day deadline no longer prevent the participant from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the participant from making the contribution. IRS Form 5498, *IRA Contribution Information*, will be amended to permit plan trustees or administrators to report these rollovers. The plan administrator or IRS trustee may rely on the certification unless it is aware of facts contrary to the self-certification. According to the IRS, the participant’s self-certification is not a waiver of the 60-day requirement because the IRS can still deny the waiver on audit if it determines the participant did not meet the requirements. The IRS can still later audit the return and determine that a rollover was not appropriate.

How will the IRS know that your client did a late rollover? Well, the IRS will know because beginning in 2017, the IRA custodian must report the rollover to the IRS. The IRS has changed Form 5498 “*IRA Contribution Information*” for 2017 to show that a late rollover was accepted. IRS Form 5498 is the form that the financial organization uses to report a rollover to the IRS. On this form the financial institution will report the late rollover contributions that have self-certified in box 13a and report the self-certification code (code C) in box 13c.

To view the rules and the certification letter go to the IRS website at: [https://www.irs.gov/pub/irs-drop/rp-16-47.pdf](https://www.irs.gov/pub/irs-drop/rp-16-47.pdf)

**The 12-Month Rule**

Only one rollover is permitted from a particular IRA to any other IRA during the one-year period (12-months) ending with the transfer from the first IRA [IRC § 408(d)(3)(B)]. Reminder: The one-year period is based on the distribution date, not rollover dates. The IRC limits a taxpayer to one rollover from all of the taxpayer’s IRAs in any one-year period.

A rollover cannot be used to “swap” property out of a retirement plan. The IRC does not authorize selling distributed property and rolling over the sale proceeds in connection with IRA-to-IRA rollovers. It blesses only rollovers of the “amount received (including money or other property)” [IRC § 408(d)(3)(A)].
IRS Announcement 2014-15 and 2014-32

Beginning in 2015, a participant can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs the participant owns. The limit will apply by aggregating all of an individual’s IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit.

Background of the One-Per-Year Rule

As was discussed above, under the basic rollover rule, a participant doesn’t have to include in his/her gross income any amount distributed to him/her from an IRA if he/she deposited the amount into another eligible plan (including an IRA) within 60 days [IRC § 408(d)(3)]. IRC § 408(d)(3)(B) limits taxpayers to one IRA-to-IRA rollover in any 12-month period. Proposed Treasury Regulation Section 1.408-4(b)(4)(ii), published in 1981, and IRS Publication 590, Individual Retirement Arrangements (IRAs) interpreted this limitation as applying on an IRA-by-IRA basis, meaning a rollover from one IRA to another would not affect a rollover involving other IRAs of the same individual. However, the Tax Court held in 2014 that you can’t make a non-taxable rollover from one IRA to another if you have already made a rollover from any of your IRAs in the preceding 1-year period (Bobrow v. Commissioner, T.C. Memo. 2014-21).

Tax Consequences of the One-Rollover-Per-Year Limit

Beginning in 2015, if you receive a distribution from an IRA of previously untaxed amounts:

- Participant must include the amounts in gross income if he/she made an IRA-to-IRA rollover in the preceding 12 months (unless the transition rule above applies); and
- Participant may be subject to the 10% early withdrawal tax on the amounts you include in gross income.

Additionally, if the participant pays the distributed amounts into another (or the same) IRA, the amounts may be:

- Treated as an excess contribution; and
- Taxed at 6% per year as long as they remain in the IRA.
Direct Rollovers

In 1992 Congress enacted The Unemployment Compensation Amendments of 1992, which became effective January 1, 1993 and changed the law to approve direct transfers from qualified plans to IRAs.

The Unemployment Compensation Amendments of 1992 introduced a new concept called “direct rollovers.” Under the direct rollover option, a participant may elect to have his or her distribution from a qualified plan or IRC § 403(b) plan paid directly to an IRA or to another qualified retirement plan.

Just like direct transfers (trustee-to-trustee), no distribution of retirement funds is made to the participant in a direct rollover. The funds transferred directly to a successor trustee or custodian. The distribution check is made out to the successor trustee or custodian, and it cannot be negotiated by the participant.

Note: IRS regulations do advise that a standard notation, DIRECT ROLLOVER, must appear on the face of the check.

Partial rollovers are allowed. The participant may elect to receive a portion of the distribution in cash and pay taxes on it, and elect direct rollover with the remaining portion and defer current taxation.

Once again, it is important to remember that with a direct rollover (trustee-to-trustee transfer) the IRA owner is never in possession of the funds. There is no constructive receipt of the IRA funds to the participant. Instead, the IRA participant would have their IRA assets transferred directly from one IRA trustee, or custodian, or plan to another plan. For example, an individual has an IRA removed from ABC Bank’s IRA plan and transferred to the custodian of the XYZ Brokerage Company’s IRA. Such direct transfers may be made as often as the IRA participant wishes. There is no 60-day rule or 12-month rule (discussed below).

Reminder: Trustee to Trustee (Direct) rollovers are not subject to the One-IRA Rollover Per-Year- Rule.

IRA Rollover Rules after EGTRRA

With the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, the Act allowed an increase in the portability rules of IRA rollovers with various types of retirement plans. The Act now allows:

- Complete portability between IRA, 401(k), 403(b), 457, SEP IRAs, and profit sharing and money purchase plan pension plans;
- Ability to rollover IRA assets into employer-sponsored plans, such as 401(k) and § 403(b) plans; and
When government employees leave their jobs, they can now roll their 457 plan assets into an IRA or other qualified plans.

Also, before the enactment of EGTRRA, after-tax assets could not be rolled over between qualified plans or 403(b) accounts and IRAs. Under EGTRRA, after-tax assets can now be rolled over from qualified plans and 403(b) accounts to Traditional IRAs (after-tax assets still cannot be rolled from IRAs to qualified plans). Of course, to roll over the assets, the participant must still satisfy their plan’s requirements for distributions.

While many see these changes as a good thing, it has created confusion and frustration for the individuals who unwittingly roll over their after-tax assets to their IRA without understanding the follow-up accounting and tax-filing requirements and the tax treatment of subsequent distributions from Traditional IRAs.

Should a participant roll over after-tax assets to their Traditional IRA, they are required to account for the after-tax assets and the pre-tax assets separately. This accounting is accomplished by filing IRS Form 8606 for the year the after-tax amount is rolled over to the IRA, and for each year the participant distributes assets from any of his/her Traditional IRA, SEP IRA or SIMPLE IRA.

This rule requiring the filing of IRS Form 8606 applies even if the rollover is made from one of the participant’s Traditional IRAs that does not include after-tax assets: all of the participant’s Traditional, SEP and SIMPLE IRAs are treated as one IRA for the purpose of calculating the taxable portion of the distribution, this is known as the “aggregation rule” [IRC § 408(d)(2)]. The information provided on IRS Form 8606 helps both you and the IRS determine the balance of the participant’s IRAs that are attributable to after-tax assets. This information also helps to ensure that the participant does not pay taxes on distributions that should be tax free.

If after the rollover of after-tax assets the participant wants to take a distribution or a Roth IRA conversion from their Traditional IRA, they cannot choose to take the assets from strictly either pre-tax or after-tax assets. Instead, until all the after-tax assets have been fully distributed, all distributions and/or Roth IRA conversions will include a pro-rata basis amount of pre-tax and after-tax assets. The instructions for filing IRS Form 8606 explain the steps for determining the taxable and nontaxable portions of the distribution and/or Roth conversion amount.

**IRA Rollovers after PPA of 2006**

Section 822 of the PPA of 2006 amended IRC § 402(c)(2)(A) to permit qualified plans (whether defined benefit or defined contribution) and 403(b) plans to accept after-tax direct rollover amounts from a qualified retirement plan, so long as the plan separately accounts for such after-tax amounts (previously only qualified defined contribution plans could accept such after-tax rollover amounts). This may entail significant accounting and programming changes. The effective date for distributions is after December 31, 2006.
Section 824 of the PPA of 2006 amended the definition of qualified rollover contribution in IRC § 408A to include additional plans. Under this expansion, in addition to the rollovers described above, a Roth IRA can accept rollovers from other eligible retirement plans, as defined in IRC § 402(c)(8)(B). The amendments made by Section 824 of the PPA of 2006 are effective for distributions made after December 31, 2007.

Prior to the enactment of Section 824, the IRC provided that a Roth IRA could only accept a rollover contribution of amounts distributed from another Roth IRA, from a non-Roth IRA (i.e., a traditional or SIMPLE IRA) or from a designated Roth account described in IRC § 402A. These rollover contributions to Roth IRAs are called “qualified rollover contributions.” A qualified rollover contribution from a non-Roth IRA to a Roth IRA is called a “conversion.” An individual who rolls over an amount from a non-Roth IRA to a Roth IRA must include in gross income any portion of the conversion amount that would be includable in gross income if the amount were distributed without being rolled over.

The PPA of 2006, Section 829, amended IRC §§ 402(c), 403(b), and 457(b) plans to provide an additional option for non-spouse beneficiaries who are eligible to receive distributions from qualified retirement, 403(b) and 457(b) governmental plans. Non-spouse beneficiaries previously were not permitted to rollover distributions from such plans. Now, if a distribution would otherwise be an eligible rollover distribution, a non-spouse beneficiary, who is a designated beneficiary as defined by IRC§ 401(a)(9)(E), may rollover the distribution to an individual retirement account or individual retirement annuity established for the purpose of receiving the distribution. The account or annuity will be treated as an “inherited” individual retirement account or annuity. This means, for example, that distributions from the inherited IRA would be subject to the minimum distribution rules applicable to IRA beneficiaries, rather than the five-year rule for distributions from a qualified plan. The effective date for distributions is after December 31, 2006.

However, it turned out that the PPA 2006 provision allowing non-spouse plan beneficiaries to do direct rollovers to inherited IRAs is more challenging than the actual law led many to believe.

**IRS Notice 2007-7**

In order to provide guidance on what are the proper rules for non-spouse beneficiaries to do a direct rollover of an inherited qualified retirement plan, the IRS on January 10, 2007 issued IRS Notice 2007-7. The notice makes it clear that this provision applies to 401(k), 403(b) and 457 plans. In addition the notice clarifies that the IRA receiving the inherited plan benefits must be a properly titled inherited IRA, which keeps the name of the decedent in the account title. The example they use is “Tom Smith as beneficiary of John Smith.”
To make things even more difficult in interpreting the law, the IRS Notice stated the following:

- The plan does not have to allow the non-spouse beneficiary a direct transfer option;
- If the plan offers the direct transfer option, it must do so on a nondiscriminatory basis; and
- If the funds are moved to an inherited IRA, the distribution rules that applied under the plan will continue to apply to the inherited IRA, unless a “special rule” applied.

Are you confused yet? The “special rule” states that in order for the non-spouse plan beneficiary not to get stuck with the plan rules (assuming that the 5-year payout rule applies) the beneficiary must take the first required distribution based on the beneficiary’s life expectancy by the end of the year following the year of the employee’s death. If this distribution is missed, the non-spouse beneficiary will not benefit from the PPA 2006 provision.

**IRS Notice 2008-30**

In 2008, the IRS issued Notice 2008-30 which allow non-spousal beneficiaries to roll over inherited qualified retirement plan assets into a Roth IRA. In addition, the new changes allow taxpayers to rollover these inherited assets from the qualified plan directly to a Roth IRA without the need to set up first a Traditional IRA. In the past, as discussed above, only a spousal beneficiary had the ability to convert an inherited qualified retirement plan into a Roth IRA. Further, even for those spousal beneficiaries who qualified, they first had to roll qualified plan assets into a Traditional IRA in order to accomplish the ultimate Roth conversion.

While these new changes offer a possible estate planning opportunity for clients and beneficiaries who inherit qualified plan assets, there are some limitations. First, the inherited plan must be one which permits these rollovers. Second, the non-spouse beneficiary must still meet the requirements already in place regarding modified adjusted gross income (MAGI). It wasn’t until 2010, that a beneficiary would not qualify for the Roth conversion if the beneficiary had MAGI over $100,000. However, beginning on January 1, 2010, the MAGI limitation was removed for Roth conversions.

**Worker, Retiree, and Employer Recovery Act of 2008**

The Workers, Retirees, And Employer Recovery Act of 2008 clarifies that all plans must permit rollovers out of a qualified retirement plans (401(k), 403(b) and 457 plans for non-spouse beneficiaries and provide notice of distribution. Effective for plans years after December 31, 2009 qualified plans must permit non-spouse rollover.
In IRS Notice 2009-75, the IRS came out with additional information and procedures for rollovers from an eligible employer plan to a Roth IRA. Below are some Q & As from IRS Notice 2009-75.

Q-1: What amount is included in gross income as a consequence of a rollover to a Roth IRA from an eligible employer plan (i.e., a qualified plan described in IRC § 401(a), an annuity plan described in IRC § 403(a), a plan described IRC § 403(b), or a governmental IRC § 457)?

A-1: (a) Rollovers to a Roth IRA of distributions that are not made from a designated Roth account. If an eligible rollover distribution from an eligible employer plan is rolled over to a Roth IRA and the distribution is not made from a designated Roth account, then the amount that would be included in gross income were it not part of a qualified rollover contribution is included in the distributee’s gross income for the year of the distribution. For this purpose, the amount included in gross income is equal to the amount rolled over, reduced by the amount of any after-tax contributions that are included in the amount rolled over, in the same manner as if the distribution had been rolled to a non-Roth IRA that was the participant only non-Roth IRA and that non-Roth IRA had then been immediately converted to a Roth IRA. Thus, special rules relating to net unrealized appreciation (NUA) at IRC § 402(e)(4) and certain optional methods for calculating tax available to participant’s born on or before January 1, 1936 are not applicable.

Q-2: What are the modified adjusted gross income limitations and joint filing requirements for a rollover to a Roth IRA of a distribution from an eligible employer plan made either before January 1, 2010 or on or after January 1, 2010?

A-2: (A) Distributions not made from a designated Roth account. Except for a distribution from a designated Roth account, an eligible rollover distribution made before January 1, 2010 from an eligible employer plan may not be rolled over to a Roth IRA unless, for the year of the distribution, the distributee’s modified adjusted gross income does not exceed $100,000 and, in the case of a married distributee files a joint federal income tax return with his or her spouse. The $100,000 limit and the requirement that a married distributee file a joint return do not apply to distributions made on or after January 1, 2010. If an eligible rollover distribution made before 2010 is ineligible to be rolled over to a Roth IRA either because the distributee’s modified adjusted gross income exceeds $100,000 or because a married distributee does not file a joint return, the distribution can be rolled over into a non-Roth IRA and then the non-Roth IRA can be converted, on or after January 1, 2010, into a Roth IRA.
Eligible Rollover Distributions

Generally, an “eligible rollover distribution” is any distribution of all or part of the balance of a qualified plan or IRA to a participant’s qualified retirement plan or IRA, except for the following:

- A required minimum distribution;
- A hardship distribution;
- Any of a series of substantially equal periodic distributions paid at least once a year over:
  - A lifetime or life expectancy;
  - The lifetime or life expectancies of participant and beneficiary; or
  - A period of 10 years or more.
- Corrective distributions of excess contributions or excess deferrals, and any income allocable to the excess, or of excess annual additions and any allocable gains;
- A loan treated as a distribution because it does not satisfy certain requirements either when made or later (such as upon default), unless the participant’s accrued benefits are reduced (offset) to repay the loan;
- Dividends on employer securities;
- The cost of life insurance coverage; and
- Generally, a distribution to the plan participant’s beneficiary.

Withholding Requirements from Qualified Retirement Plans

Generally, if an “eligible rollover distribution” paid to an employee or the employee’s spouse/beneficiary (distributee) from a qualified retirement plan is paid directly to the plan distributee, the payer is subject to 20% mandatory withholding under IRC § 3405(c), and the distributee/participant cannot elect out. This applies even if the participant plans to roll over the distribution to a Traditional IRA. The only way to avoid the 20 percent withholding is to have the distribution paid directly to an eligible retirement plan (direct transfer).

Pursuant to IRC § 3405(c)(2), an eligible rollover distribution that a distributee elects, under IRC § 401(a)(31)(A), to have paid directly to an eligible retirement plan (including a Roth IRA) is not subject to mandatory withholding, even if the distribution is includable in gross income. Also, a distribution that is directly rolled over to a Roth IRA by a non-spouse beneficiary pursuant to IRC § 402(c)(11) is not subject to mandatory withholding. However, there are exceptions to this rule:

- The total distribution is less than $200;
- The distribution consists solely of employer securities, plus cash of $200 or less in lieu of fractional shares [IRC § 402(e)(4)(E)];
• If the distribution consists of securities of the employer corporation plus cash and other property, the maximum that may be withheld is the value of the cash and other property [IRC § 3405(e)(8)];
• There is no withholding on dividends paid to participants on employer securities held in the plan; and
• All net unrealized appreciation (NUA) from employer securities is not included in gross income.

IRA Rollover Withholding Rules

Periodic payments, defined as payments made at regular intervals for more than one year, are subject to withholding of taxes at the same rate as wages. The participant can elect-out of having anything withheld from a periodic payment, so the withholding is voluntary.

Non-periodic distributions from an IRA are subject to withholding of a flat rate of 10 percent, unless the participant elects-out of the withholding. So the withholding is voluntary.

Reporting IRA Rollovers to the IRS

Participants must report any rollover from one Traditional IRA to the same or another Traditional IRA on Form 1040, lines 15a and 15b or on Form 1040A, lines 11a and 11b.

Enter the total amount of the distribution on Form 1040, line 15a or on Form 1040A, line 11a. If the total amount on Form 1040, line 15a or on Form 1040A, line 11a was rolled over, enter zero on Form 1040, line 15b or on Form 1040A, line 11b. If the total distribution was not rolled over, enter the taxable portion of the part that was not rolled over on Form 1040, line 15b or on Form 1040A, line 11b. Put “Rollover” next to line 15b, Form 1040 or line 11b, Form 1040A. See the form instructions.

The IRS requires trustees or issuers of contracts used for Individual Retirement Arrangements (IRAs) to submit IRS Form 5498 to the IRS and to the IRA participant by May 31 each year. This form reports the fair market value, any rollovers and contributions made to a Traditional IRA, Roth IRA, SEP IRA or SIMPLE IRA and recharacterizations of an IRA contribution.

Variety of IRA Rollovers

There are four broad varieties of IRA rollovers (see Table 5.1). They are:

• Like kind IRA-to-IRA rollovers—that is a Traditional IRA-to-Traditional IRA rollover or a Roth IRA to Roth IRA rollover;
• Traditional IRA-to-Roth IRA rollovers;
• Traditional IRAs to-qualified plans (does not include after tax money [IRC § 402 (c)(8)(B)(iii)]; and
• Qualified plan-to Traditional IRA rollovers (both pre-tax and after-tax amounts [IRC § 402(c)(8)(B)(i)]. Types of qualified retirement plans:
  o Defined benefit pension plan;
  o Money purchase and target benefit plan;
  o Profit-sharing plans;
  o 401(k) plans;
  o Tax-deferred savings plans;
  o Stock ownership plans;
  o Keogh plans;
  o 403(b) plans; and
  o Section 457 governmental deferred compensation plans.

Table 5.1
Rollover Portability Table

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<tr>
<th>Rolling Funds From</th>
<th>401(k)</th>
<th>403(b)</th>
<th>457(b) Gouvermental</th>
<th>IRA</th>
<th>SEP IRA</th>
<th>SIMPLE IRA</th>
<th>Roth IRA</th>
<th>Designated Roth Account</th>
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<td>No</td>
<td>Yes</td>
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</tr>
</tbody>
</table>

1. Rollovers from SIMPLE IRAs only allowed after two years of participation.
2. Must have a separate account.
3. Must be an in-plan rollover.
4. If it is a direct trustee-to-trustee transfer.
5. Beginning in 2015, only one rollover allowed in any 12-month period.
6. After December 18, 2015 and only after two years of participation in the SIMPLE plan.

Note: RMDs from a qualified retirement plan or IRA cannot be rolled over [IRC § 402(c)(4)(B)]. The trap is that the first year distribution received in any year for which a distribution is required is considered part of the RMD for that year and thus cannot be
rolled over. Another trap of this rule is that the participant first Distribution Year is not the year in which the required beginning date (RBD) occurs; it is the year before the RBD. Thus the first Distribution Year is the year the participant reaches age 70½ (or retires as the case may be), even though the first RMD does not have to be taken until April 1 of the following year. Any distribution received on or after January 1 of the first Distribution Year will be considered part of the RMD for that year (until the entire RMD has been distributed), and thus cannot be rolled over [Treas. Reg. 1.402(c)-2, A-7(a)].

**Advisory Opinion 2005-23A**

In the Advisory Opinion 2005-23A, the DOL answered the following three questions:

The first question was:

"Is an individual who advises a participant, in exchange for a fee, on how to invest the assets in the participant’s account, or who manages the investment of the participant’s account, a fiduciary with respect to the plan within the meaning of section 3(21)(A) of ERISA?"

In answering the question, the DOL said, “yes.”

The second question was:

"Does a recommendation that a participant roll over his or her account to an individual retirement account (IRA) to take advantage of investment options not available under the plan constitute investment advice with respect to plan assets?"

The DOL answered this question by saying that,

"merely advising a plan participant" about those issues is not fiduciary investment advice. Where, however, a plan officer or someone who is already a plan fiduciary responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from a plan, that fiduciary is exercising discretionary authority respecting management of the plan and must act prudently and solely in the interest of the participant”

Moreover, if, for example, a fiduciary exercises control over plan assets to cause the participant to take a distribution and then to invest the proceeds in an IRA account managed by the fiduciary, the fiduciary may be using plan assets in his or her own interest, in violation of the prohibited transaction rule in ERISA section 404(6)(b)(1).”

It seems clear that the DOL does not think that the mere recommendation of a distribution or recommendations regarding investments for an IRA are fiduciary acts. In fact, in the advisory opinion, the DOL states:
“The Department does not view a recommendation to take a distribution as advice or a recommendation concerning a particular investment (i.e., purchasing or selling securities or other property) as contemplated by regulation §2510.3-21(c)(1)(i). Any investment recommendation regarding the proceeds of a distribution would be advice with respect to funds that are no longer assets of the plan.”

Therefore, the issue is whether such recommendations can become fiduciary acts simply because they are made by someone who is already a plan fiduciary, as opposed to someone who is not. The DOL concludes that such recommendations are the exercise of

“discretionary authority respecting the management of the plan.”

However, a fiduciary for investment advice does not have “discretionary authority respecting the management of the plan.” That is because, under ERISA, a person is a fiduciary only “to the extent” of their specific responsibilities; beyond that, a person may be a service provider, but is not a fiduciary.

The DOL’s third question and answer discusses the situation where an advisor who is not a fiduciary makes such recommendations. The answer simply re-affirms the prior conclusion that the non-fiduciary advisor would not be a fiduciary for purposes of distribution even if the advisor

“recommends that a participant withdraw funds from the plan and invest the funds in an IRA ... if the advisor will earn management or other investment fees related to the IRA.”

The DOL concluded at the time that merely advising a participant to take a distribution is not considered “investment advice” that makes the advisor a fiduciary, even if the advice also includes a recommendation as to how the distribution should be invested. Such advice is not, in the DOL’s view, advice regarding specific investments of plan assets. It follows that, once the assets are distributed, the advisor’s advice regarding investments would relate to assets that no longer are “plan assets.” The DOL also stated that a planner who recommends particular investments for assets to be rolled over to an IRA in this scenario does not engage in a prohibited transaction, even if the planner will receive management or investment fees from that IRA.

**The bottom line:** Advisory Opinion 2005-23A allowed advisors (who were not considered fiduciaries of the plan), to make rollover and distribution decisions without being considered a fiduciary under ERISA standards.

All of this will certainly change with the DOL’s Conflict of Interest Rule.
IRA Rollovers and the DOL Conflict of Interest Rule

Since the release of Advisory Opinion 2005-23A, the Department of Labor (DOL), has changed its mind, it now believes that an advisors’ recommendation, even if not accompanied by a specific recommendation on how to invest assets, should be treated as “investment advice” and should be covered by Title 1 of ERISA, including enforcement of Section 501(a)(1) which permits civil lawsuits to be brought by participants or beneficiaries of an employee benefit plan and now an IRA.

According to the DOL Conflict of Interest Rule (aka, the new Fiduciary Rule), which is scheduled to phase-in on June 9, 2017 and be fully compliant by January 1, 2018, if an advisor suggests to a client that they rollover their 401(k) into an IRA and purchase “X” investment, there are two recommendations there which would be subject to the new fiduciary standards. The recommendation to purchase investment X would have to meet those standards but, so would the actual recommendation to complete a rollover in the first place.

Per the new DOL Conflict of Interest Rule:

“recommendations with respect to rollovers, distribution, or transfers from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer or distribution should be made will be subject to fiduciary standards”.

This additional requirement places a new burden on advisors, to increase their knowledge of the benefits and drawbacks of various rollover options and to make sure that he/she is properly evaluating the merits of a rollover in order to avoid potential regulatory issues.

Many believe that the new fiduciary rule should change almost nothing in the rollover evaluation for the educated advisor and for the advisor who was — and has been all along — doing appropriate due diligence prior to recommending a rollover (following FINRA 13-45 as discussed below). That said, there will certainly be more scrutiny in situations where clients are moved from a lower-fee account to a higher-fee account than there would be if client fees in the new account were the same, or lower. But, that has (or should have) always been the case.

Unfortunately, there’s no magic bullet or single answer for advisors looking to beef up their “Why did you recommend that rollover” defense. Rather, a move to a higher-fee account — whether managed money or not — could be justified by any one or combination of the following:

- A desire to consolidate funds;
- Simplified required minimum distributions;
- Estate-planning concerns;
- More appropriate investments;
- Enhanced service;
• More favorable distribution options (many plans don’t offer systematic distributions);
• More favorable withholding options; or
• Ability to utilize IRA-only 10% penalty exceptions.

The above list is not all-inclusive, but it does highlight common reasons why a 401(k)-to-IRA rollover could be justified, even in light of higher fees. Of course, higher fees may not be the only downside of a rollover; other disadvantages would have to be factored in as well.

Again, this should not be anything new for advisors. But in a post-fiduciary rule world, it will be even more important for advisors to follow a process. The 3-Ds:

• Determine: Determine the needs and objectives of the client;
• Demonstrate: Demonstrate that the recommendation is in the client’s best interest; and
• Document: Document their justifications and disclosures to clients.

While there’s little doubt the DOL Conflict of Interest Rule was created to address the flow of retirement funds from ERISA covered plans (subject to fiduciary oversight) to IRAs (which were not subject to the same oversight) the new rule is agnostic as to which direction retirement savings flows.

If you’re moving money from one account subject to fiduciary oversight to another account subject to fiduciary oversight, the scrutiny to which you’ll be subject will be roughly the same. Thus, most 401(k)-to-401(k), 401(k)-to-IRA, IRA-to-IRA, and IRA to 401(k) rollovers will be subject to the same rules. “You must place your client’s interest above your own.”

FINRA Regulatory Notice 13-45

On December 30, 2013 the Financial Industry Regulatory Authority (FINRA) and the U.S. Securities and Exchange Commission (SEC) released FINRA Notice 13-45 which provides guidance on brokers’ responsibilities concerning IRA Rollovers. FINRA also issued an investor alert, “The IRA Rollover: 10 Tips to Making a Sound Decision.” Highlighting issues (including tax consequences, fees and expenses, and conflicts of interest) that FINRA believes an investor should be aware of in deciding whether to rollover assets to an IRA. You can view the alert at: http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/RetirementAccounts/P436001

Background

for Participants” (you can view the report at: http://www.gao.gov/products/GAO-13-30) urging the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) –the primary regulators of employer-sponsored retirement plans and, with respect to the IRS, IRAs—to take action to improve the rollover process for participants. The GAO report was particularly critical of the information and disclosures that financial service firms provide to participants when counseling them on distribution options. Specifically, the GAO report concluded that financial service firms generally encourage IRA Rollovers without fully explaining the options available to their clients and without making sound determinations that an IRA Rollover is in particular investors’ best interests. The GAO particularly noted that “[much] of the information participants receive is through the marketing efforts of service providers touting the benefits of IRA Rollovers and is not always objective.” Perceived issues with the IRA rollover process have become of increasing concern because assets are held in IRA accounts and other similar plans and traditional pension plans.

FINRA and SEC Examinations

FINRA in its 2014 examination priorities, stated that

“it shares the GAO’s concerns that investors, may be misled about the benefits of rolling over assets…to an IRA”

FINRA indicated that it will review brokers’ marketing materials and supervision with respect to IRA rollover practices and will evaluate securities recommendations made in the context of IRA Rollovers to determine whether they comply with FINRA’s suitability standards under Rule 2111, FINRA further urged brokers to review guidance in Notice 13-45 (discussed in more detail below) and its prior guidance in Notice 13-23 regarding marketing materials that claim an IRA is “free” or has “no fee.”

Rollovers to IRAs: FINRA Regulatory Notice 13-45

FINRA issued Notice 13-45 to “remind [broker-dealer] firms of their responsibilities” when recommending rollovers to IRAs and marketing IRAs and associated services. FINRA noted that a recommendation to roll over retirement plan assets to an IRA typically involves securities recommendations subject to FINRA rules regarding suitability and that related marketing must be “fair, balanced and not misleading.” Highlights of Notice 13-45's guidance include:

- IRA rollover recommendations should reflect consideration of various factors related to the investor's individual needs and circumstances. FINRA suggested that a broker-dealer evaluating whether to recommend that a client roll over retirement assets to an IRA should consider the importance of various factors to particular investors. The factors FINRA specifically identified include:
  - The broad range of investment options available through an IRA, compared to the potentially more limited options available in a client's plan;
o The various investment-related and plan or account fees that a client may incur for investments in an IRA or plan;
o The levels of service available under an IRA and a client's plan
o The tax consequences of each option, including with respect to penalties that may be assessed if a client withdraws funds before age 59½, required minimum distribution rules of the IRS that apply when a client attains age 70½, and the tax consequences of rolling over employer stock held in a plan to an IRA:
  - **Employer Stock**: With respect to employer stock, IRS rules provide that—if an investor receives a lump-sum distribution of his or her retirement plan assets, including an in-kind distribution of employer stock, and holds the stock in a non-retirement account—the investor will pay tax at the ordinary income rate on his or her cost basis in the stock. But, when the stock is sold, the investor will pay tax on the stock's subsequent appreciation at the more favorable rate for long-term capital gains. In contrast, if the stock is rolled over in kind to an IRA, the stock's subsequent appreciation (along with its cost basis) will be taxed as ordinary income when it is distributed from the IRA. FINRA notes that brokers will need to balance the possible negative tax consequences of rolling over the stock to an IRA and liquidating the holdings against the possible risks of the investor holding high concentrations of stock. This issue highlights the complexity of the matters FINRA believes brokers should consider in recommending investors roll over assets to IRAs; and

o The different levels of protection that assets held in IRAs and plans have from creditors and legal judgments (such as in the event of a bankruptcy filing).

To evaluate these factors, a broker-dealer may need to obtain detailed information about the plan in which a client's assets are currently invested, including information about investment options and related expenses, plan-level fees (including recordkeeping, compliance, and trustee fees), and plan features (including distribution rights and services related to the plan). Further, if the participant is also eligible to transfer assets to a new employer's plan, the broker-dealer may find it necessary to obtain and evaluate similar information about the new employer's plan as well. Based on these factors, FINRA seems to expect that representatives should have some knowledge of a number of areas that may go beyond their traditional training, including taxation of retirement distributions, bankruptcy protection of retirement assets, and the rules governing qualified retirement plans (including a particular plan's provisions). FINRA also notes that the list of considerations above is not exclusive and other considerations may apply depending on a client's circumstances:

- **Broker-dealers should review their retirement services activities to assess conflicts of interest in recommending IRA rollovers.** Notice 13-45 explains that financial advisors (including broker-dealers and investment advisors) typically
have incentive (e.g., receipt of a commission or asset-based fee) to recommend that a client roll over assets to an IRA. But, financial advisors typically have no incentive to recommend that a client leave assets in his or her previous employer's plan or transfer them to a new employer's plan. FINRA indicated that similar conflicts may exist for brokers and associated persons responsible for educating plan participants about their distribution options if their compensation depends on the number of IRAs opened at the broker. Notice 13-45 urges brokers to evaluate activities with respect to rollovers to determine whether their supervision is adequate "to reasonably ensure that conflicts do not impair the judgment" of registered representatives and associated persons about a client's best interests and that they "neither confuse investors nor interfere with important educational efforts."

- **Broker-dealers should ensure their recommendations and educational information regarding IRA rollovers do not violate FINRA's suitability rule.** FINRA's Rule 2111, the suitability rule, requires that broker-dealers and their associated persons have a reasonable basis to believe that a recommended transaction or investment strategy involving a security is suitable for a customer. Notice 13-45 indicates that recommendations regarding IRA rollovers would typically be subject to this rule and, thus, must be supported by a reasonable basis that the recommendation is suitable for a client. FINRA noted that, in the case of an IRA rollover recommendation, a broker-dealer must obtain information about a client's options, including "tax implications, legal ramifications, and differences in services, fees and expenses," and that both the immediate consequences and long-range effects of a recommendation should be considered.

Where a broker's associated person offers educational information to participants regarding rollovers, FINRA indicates that the broker should adopt procedures that ensure that the educational information does not result in recommendations for purposes of the suitability rule. According to FINRA, these procedures should include training on which statements and compensation arrangements could be viewed as resulting in recommendations.

- **Broker-dealers should ensure that communications with the public regarding IRA rollovers are fair and balanced.** FINRA's Rule 2210 requires that brokers' communications with the public are based on the principles of fair dealing and good faith, are fair and balanced, and provide a sound basis to evaluate the facts about securities and services. With respect to broker-dealers' marketing of IRAs and related services, Notice 13-45 states that oral and written sales materials should not imply that a client's "only choice, or only sound choice, is to roll over her plan assets to an IRA sponsored by the broker-dealer" and must include a discussion and comparison of other available options and their fees. Notice 13-45 further notes, as previously stated in FINRA Regulatory Notice 13-23, that marketing materials should not include claims that an IRA is "free" or carries "no fee" if investors will, in fact, incur account- or investment-related fees.

Notice 13-45 further indicates that written supervisory procedures and training programs should be reviewed and updated as necessary in light of Notice 13-45's guidance. FINRA
followed Notice 13-45 with the investor alert, "The IRA Rollover: 10 Tips to Making a Sound Decision," which includes tips for investors that generally parallel the concerns that FINRA raised in Notice 13-45.

The issuance of Notice 13-45 and the inclusion of IRA rollovers as examination priorities, along with the recent GAO report discussed above, are consistent with the trend toward increasing regulatory scrutiny of the IRA market. IRA rollovers are also receiving attention from the DOL, which indicated in its comments to the GAO report that its pending project to revise its regulation on the definition of a "fiduciary" may address many of the GAO's concerns. Because IRA rollovers will likely increase as more Americans reach retirement age, we can expect further regulatory activity in this area—including possibly from the IRS. Accordingly, in light of the converging regulatory scrutiny involving IRA rollovers, broker-dealers and investment advisors—as well as other financial institutions that provide IRA services—should consider reviewing and updating their IRA rollover practices, marketing activities, supervisory procedures, and training programs.

**Additional Factors to Consider**

Further complicating matters is the fact there is no one-size-fits-all template that can be used to determine which option is best for a client. Each client — and in fact, each client’s retirement plan — must be evaluated individually, based on its own merit. And there is no shortage of variables to consider either. For instance, in recommending a rollover (or a “don’t rollover”) or distribution, an advisor should, among other factors, consider impacts relating to:

- Fees;
- Available investments;
- Services provided;
- The 10 percent early distribution penalty;
- Creditor protection;
- Simplicity/convenience; and
- Required minimum distributions.
Chapter 5
Review Questions

1. Of the following, which Section of the Internal Revenue Code (IRC) allows the continuous tax-deferral of a rollover?

   ( ) A. IRC Section 402(c)
   ( ) B. IRC Section 401(a)(9)
   ( ) C. IRC Section 451(b)
   ( ) D. IRC Section 501(d)(3)

2. Which of the following statements about a “direct rollover” is FALSE?

   ( ) A. There is no distribution to the participant.
   ( ) B. There is no 60-day rule.
   ( ) C. They are limited to one IRA-to-IRA rollover per 12-month period.
   ( ) D. Partial rollovers are allowed.

3. Should a participant rollover after-tax assets to their Traditional IRA, they are required to account for the after-tax assets on which of the following IRS Forms?

   ( ) A. IRS Form 5329
   ( ) B. IRS Form 4329
   ( ) C. IRS Form 8888
   ( ) D. IRS Form 8606

4. To avoid taxable distribution treatment from an “in-direct rollover”, the IRA distribution must be re-deposited back into the same or a new IRA no later than how many days after the date the distribution is received by the taxpayer?

   ( ) A. 30 days
   ( ) B. 60 days
   ( ) C. 90 days
   ( ) D. 120 days

5. Non-periodic distributions from an IRA are subject to withholding of a flat rate of what percent, unless the participant elects-out of the withholding?

   ( ) A. 25%
   ( ) B. 10%
   ( ) C. 20%
   ( ) D. 15%
CHAPTER 6

IRA DISTRIBUTIONS DURING PARTICIPANTS LIFETIME

Overview

Since IRAs were designed to encourage Americans to save for retirement and not as an estate planning tool, sooner or later, the IRA participant will be forced to withdraw savings from his or her IRA under IRC § 401(a)(9). These withdrawals are called distributions.

This chapter will provide an in-depth review of the various IRA distribution timelines, during the participant’s lifetime. In addition, at the end of the chapter, we will examine the new Qualified Charitable Distribution rules.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Outline the three IRA distribution timelines;
- Explain the rules and penalties for distributions prior to age 59 ½ under IRC § 72(t)(1), and how to avoid penalties using the exceptions of IRC § 72(t)(2);
- Apply the rules for distributions made from an IRAs during the ages from 59 ½ to age 70;
- Observe the required minimum distribution (RMD) rules under IRC § 401(a)(9);
- Identify the required beginning date (RBD) for qualified retirement plans and IRAs;
- Calculate required minimum distributions (RMDs) during the participant’s lifetime after reaching the required beginning date (RBD) using various IRS tables; and
- Describe new rules for Qualified Charitable Distributions.

IRA Distribution Timelines

Distributions (withdrawals) from IRAs during the IRA participant’s lifetime follow three principle age/timeline rules. They are:

- *Distributions made prior to age 59½.* A distribution prior to age 59½ may be subject to an early premature distribution tax [IRC 72(t)(1)]:
• **Distributions between ages 59½ to age 70.** An IRA participant can withdraw any amount of the IRA but it will be included in income and taxed in the year of distributions [IRC § 408(d)(1)]. There is another rule to be concerned about and that is if the distribution comes from a non-deductible IRA. A distribution from a non-deductible IRA must follow the aggregation rules, on a pro-rata basis [IRC §408(d)(2)]; and

• **Distributions after age 70½.** The final age and probably the most important is for participant’s who have reached the age 70½. At this age, the participant is required to take a minimum distribution over his or her life expectancy [IRC § 401(a)(9)]. **Note:** The Workers, Retirees, And Employer Recovery Act of 2008 (WRERA) suspended the RMD requirement only for 2009 for participants and beneficiaries of any defined contribution plan under IRC § 401(a), IRC § 403(a) or IRC § 403(b); any governmental IRC § 457 plan; or “an individual retirement plan.”

**Distributions Prior to Age 59½**

To discourage IRA participants from taking distributions from their qualified retirement plans and individual retirement accounts, Congress enacted a special 10% addition to tax (often incorrectly referred to as a penalty—it actually isn’t phrased as such). It applies to taxpayers who take distributions “too early” from their retirement plans, generally before age 59½. However, under certain fact patterns the 10% distribution doesn’t apply to some or all of the distribution.

Many but not all, of the exceptions are the same for distributions from qualified retirement plans as for IRAs. For some exceptions, determining the taxpayer’s qualification for the exception is fairly easy—but for others it is not so clear, even when all parties agree on the facts and that they have been properly documented.

**The Exceptions**

The 10% addition to tax itself is found in IRC § 72(t)(1):

<table>
<thead>
<tr>
<th>IRC § 72(t)(1) Imposition of Additional Tax.</th>
</tr>
</thead>
<tbody>
<tr>
<td>If any taxpayer receives any amount from a qualified retirement plan as IRC § 4974(c), the taxpayer’s tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount, which is includable in gross income.</td>
</tr>
</tbody>
</table>

However, under IRC § 72(t)(2) the IRS allows overall 14 exceptions to avoid IRC § 72(t)(1) 10% addition to tax. They differ for qualified retirement plans and IRAs. Most of the exceptions are based on hardship and/or special use exemptions. For the IRA there are 10 exceptions. They are:
• **Attainment of age 59½.** Under IRC § 72(t)(2)(A)(i) distributions made on or after the date on which the IRA participant attains age 59½;

• **Death.** Under IRC § 72(t)(2)(A)(ii) distributions upon death of the IRA participant, IRA assets can be distributed to a beneficiary or the estate without incurring the 10% excise tax on early distributions. However, in addition to income taxes, the IRA may be subject to federal estate taxes and or state estate or inheritance taxes;

• **Disability.** IRC § 72(t)(2)(A)(iii) states that the 10% addition to tax does not apply to an individual who is disabled within the meaning of IRC § 72(m)(7). IRC § 72(m)(7) defines disability. For purposes of this section, an individual shall be considered to be disabled if he/she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration;’’

• **Series of Substantial Equal Periodic Payments.** Under IRC § 72(t)(2)(A)(iv) the exception rule exists for substantially equal withdrawals from an IRA based on life expectancy. The IRS allows a person to receive distributions from an IRA before age 59½ without the 10% excise tax if the withdrawals are part of a series of substantially equal payments over the person’s life (based on life expectancy tables) or over the lives of the person and the beneficiary (joint life expectancies). An IRS-approved distribution method must be used and the person must take at least one distribution annually for this exception to apply;

• **Medical Expenses.** Under IRC § 72(t)(2)(B) distributions made to an IRA participant, to the extent such distributions do not exceed the amount allowable as a deduction under IRC § 213 to the IRA participant for amounts paid during the taxable year for medical care (determined without regard to whether the participant itemizes deductions for such taxable year);

• **Health Insurance Premiums.** Under IRC § 72(t)(2)(D) an IRA participant who is unemployed may take a distribution from his or her IRA to pay for health insurance premiums for the individual, a spouse, or dependents. To qualify for this exception, the participant must have received unemployment compensation under a federal or state law for at least 12 weeks [IRC § 72(t)(2)(D)(i)(I)]. Also, the distribution from an IRA must be made in either the year unemployment compensation is received or the following year [IRC § 72(t)(2)(D)(i)(II)]. The withdrawal from the IRA, however, cannot exceed the amount actually spent on health insurance premiums [IRC § 72(t)(D)(i)(III)]. This exception rule also applies to self-employed participants (workers) who would have received unemployment compensation, if not for the fact that they are self-employed [IRC § 72(t)(2)(D)(iii)];

• **Higher Education Expenses.** Section 203 of the Tax Reform Act of 1997 added IRC § 72(t)(2)(E), which provides that the additional 10-percent tax does not apply to IRA distributions for qualified higher education expenses of the IRA owner, the owner’s spouse, or a child or grandchild of either. Qualified higher education expenses include tuition, supplies, and, for students who are at least half-time, room and board;
• “First Time” Home Buyer Expenses. Section 303 of the Tax Reform Act of 1997 added IRC § 72(t)(2)(F), which provides that the additional 10-percent tax does not apply to IRA distributions to acquire a first-time home for the IRA owner or a member of his or her family. To qualify, the distribution must be used for costs normally associated with acquiring a principal residence and the IRA owner (and if married, the owner’s spouse), generally must not have an ownership interest in a principal residence for the previous 2 years (24 months). If distributed money is not used for such purpose, the money can be re-contributed by the 120th day after the distribution to the IRA without incurring the 10-percent tax. This exception for a first-time home purchase is subject to a lifetime cap of $10,000 for each IRA owner; thus, an individual and his or her spouse would each be subject to a separate $10,000 lifetime cap;

• IRS Levy. Section 3436 of the IRS Restructuring Act added IRC § 72(t)(2)(A)(vii), which provides that the additional 10-percent tax does not apply to a distribution from a qualified retirement plan, including an IRA, that is made on account of a levy under IRC § 6331 on the qualified retirement plan. However, ordinary income taxes still apply;

• Distributions Made To A Reservist. The Pension Protection Act (PPA) of 2006 enacted a special provision for reservists while on active duty (commencing after September 11, 2001 and before 2008) to be able to take a distribution from their IRA and avoid the addition to tax. In 2008, the Heroes Act makes permanent this exception for withdrawals by reservists call to active duty. Reservists must be called to duty for a period of at least 180 days or for an indefinite period. When the participant returns to employment with his or her employer, the participant may repay all or any part of the distribution within the two-year period after the end of active duty. Repaid contributions are not deductible; and

• Distribution to a Qualified Public Safety Employee. The Pension Protection Act (PPA) of 2006 added IRC § 72(t)(10), which provides that in case of a distribution to a qualified public safety employee from a governmental defined benefit plan, IRC § 72(t)(2)(A)(v) is applied by substituting age 50 for age 55. Thus, the 10% additional tax on early distributions under IRC § 72(t)(1) does not apply to a distribution from a governmental defined benefit plan made to a qualified public safety employee who separates from service after attainment of age 50. For the purposes of IRC § 72(t)(10), the term “qualified public safety employee” means an employee of a state or of a political subdivision of a state (such as a county or city) whose principal duties include services requiring specialized training in the area of police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the state, or the political subdivision of the state. This exception to the 10 percent additional tax applies to distributions made after August 17, 2006. The Protecting Americans from Tax Hikes (PATH) Act of 2015 expands the provision to include U.S. Capitol Police offers, Supreme Court Police officers, and diplomatic security special agents. H.R. 2146, the Defending Public Safety Employees’ Retirement Act, which was enacted on June 29, 2015, previously expanded the provision to cover federal law enforcement officials but inadvertently omitted the other categories of public safety officers.
Series of Substantial Equal Periodic Payments

Under IRC § 72(t)(2)(A)(iv) the additional tax does not apply to distributions that are:

- Part of a series of substantially equal periodic payments (not less frequently than annually) (SOSEPP); and
- Made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary.

Calculating the SOSEPP Payment

Under IRS Notice 89-25 and Revenue Ruling 2002-62, payments are considered to be substantially equal periodic payments under IRC § 72(t)(2)(A)(iv) if they are made in accordance with the following calculation methods:

- Required Minimum Distribution (Life Expectancy) method. Under the “RMD method,” the annual payment for each year is determined by dividing the account balance for that year by the factor from the chosen life expectancy table for that year. Under this method, the account balance, the factor from the chosen life expectancy table and the resulting annual payments are re-determined for each year;
- Amortization method. Under the “amortization method,” the annual payment for each year is determined by amortizing the account balance, in level amounts, over a specified number of years determined using the chosen life expectancy table and the chosen interest rate. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year; and
- Annuity method. Under the “annuitization method,” the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer’s age and continuing for the life of the taxpayer (or the joint lives of the individual and beneficiary). Under this method, the account balance, the annuity factor, the chosen interest rate, and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

Modification of SOSEPP

IRC § 72(t)(4) mandates that the participant cannot modify SOSEPP payments until the later of five (5) years after the date of the first payment or the date the participant attains age 59½. Once this ending date has passed, payments may be freely taken from the plan without the 10% addition to tax (or the series may be suspended completely).

If the series of substantially equal periodic payments is modified before this time period expires, all payments in the series lose the shelter of the exemption, and the penalty
applies, retroactively and with interest, to all pre-age 59½ distributions. The only codified exception to this rule is that if the series is modified “by reason of death or disability” there is no penalty.

However, in the event of a declining market such as we saw in 2000-2002, many participants experienced a substantial decline in their retirement account balances. And of course, if they were taking a SOSEPP during that time period, they would have seen their account balances drop drastically. As a result, they were faced with the potential of running out (or nearly running out) of funds before their payment (modification) period expired. They were dealing with the possibility of having little or no money left for future retirement years. There was also a question whether, if they ran out of funds before their payment schedule expired, would they would have to pay a penalty for modifying their payments (because the payments ceased).

Increasing pressure was being placed on the Internal Revenue Service to provide relief, or, at the very least, guidance to deal with these situations. And, the IRS did respond with Revenue Ruling 2002-62.

**Revenue Ruling 2002-62**

Relief did come to those participants who were taking SOSEPPs, and whose portfolios were devastated by market conditions in 2001, when the IRS passed Revenue Ruling 2002-62. Under this Revenue Ruling the IRS made it clear that IF funds in a participant’s individual account plan or an IRA were exhausted (because they are following an acceptable method of a series of substantially equal periodic payments), they will not be subject to a 10% addition to tax under IRC § 72(t)(1) as a result of not receiving series of substantially equal periodic payments, and the resulting cessation of payments will not be treated as a modification of the series of payments.

**Example:** Paul at age 51, began taking out $100,000 a year from his IRA using the amortization method. Under IRC § 72(t)(4), Paul must continue taking such payments until age 59½. By age 57, taking such payments has completely depleted his IRA and, as a result, the payment schedule stops. Under Revenue Ruling 2002-62, Paul will not face the penalty or interest for modifying such payments.

**One time change allowed:** More importantly, this Revenue Ruling 2002-62 allowed the participant (Paul) to make a one-time change-of-the-method they currently were using to calculate payments. A participant who began distributions in a year using either the amortization method or the annuitization method may – in any subsequent year – switch to the RMD method to determine the payment for the year of the switch and all subsequent years. Doing so will not be considered a modification subjecting them to retroactive taxes. Once such a change is made, the RMD method must be followed in all subsequent years. Any subsequent change will be a modification (AND THEREFORE A TAXABLE EVENT) for purposes of IRC § 72(t)(4). Because the required minimum distribution method produces the lowest payment amount, participants will be able to
keep more funds in their IRAs. Therefore, because the RMD method produces a much lower payment, a participant needs to be certain that switching to this method will still provide enough funds to live on. If the switch is made and the participant later decides he/she needs more money from his/her IRA, taking an extra distribution will be considered a modification and trigger the retroactive tax and interest.

**Effective dates:** For a series of periodic payments that began on or after January 1, 2003, this Ruling replaces the guidance in Q&A-12 of Notice 89-25. For a series of periodic payments that begins in 2002, this Ruling may be used. If a series of periodic payments began in a year before 2003 (and satisfied IRC § 72(t)(2)(A)(iv)), the method of calculating the payments can be changed at any time to the RMD method, including the use of a different life expectancy table.

**Interest rates:** An important part of the Ruling is the ceiling on interest rates. Rev. Ruling 2002-62 switched from the concept of a “reasonable interest rate” to a ceiling rate (see Table 6.1) that is not more than 120 percent of the federal ‘mid-term’ assumed federal rate” (AFR). This rate is a specific reference rate for three to nine-year fixed term investments instead of an average rate for a variety of investments (stocks, bonds, etc.) that was used to calculate a “reasonable interest rate” under the old rule. The fixed rate would ordinarily be much lower than expected rate of return on these other investments. The effect of this change was to reduce the maximum payments that can be taken.

**Table 6.1**
120% Mid-Term Applicable Federal Rates (AFR), Table 1

<table>
<thead>
<tr>
<th>Month</th>
<th>Year</th>
<th>Annual Rate</th>
<th>Semia Annual Rate</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2017</td>
<td>2.35%</td>
<td>2.34%</td>
<td>2.33%</td>
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</tr>
<tr>
<td>May 2017</td>
<td>2.45%</td>
<td>2.44%</td>
<td>2.43%</td>
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</tr>
<tr>
<td>April 2017</td>
<td>2.55%</td>
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<td>2.52%</td>
<td>2.52%</td>
<td></td>
</tr>
<tr>
<td>March 2017</td>
<td>2.47%</td>
<td>2.45%</td>
<td>2.44%</td>
<td>2.44%</td>
<td></td>
</tr>
<tr>
<td>February 2017</td>
<td>2.53%</td>
<td>2.51%</td>
<td>2.50%</td>
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<td></td>
</tr>
<tr>
<td>January 2017</td>
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<td>2.34%</td>
<td>2.34%</td>
<td></td>
</tr>
<tr>
<td>December 2016</td>
<td>1.76%</td>
<td>1.75%</td>
<td>1.75%</td>
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<tr>
<td>November 2016</td>
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<td>1.60%</td>
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<tr>
<td>October 2016</td>
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<td>1.55%</td>
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<tr>
<td>September 2016</td>
<td>1.47%</td>
<td>1.46%</td>
<td>1.46%</td>
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<tr>
<td>August 2016</td>
<td>1.43%</td>
<td>1.42%</td>
<td>1.42%</td>
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<tr>
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<td>1.70%</td>
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<tr>
<td>June 2016</td>
<td>1.70%</td>
<td>1.69%</td>
<td>1.69%</td>
<td>1.68%</td>
<td></td>
</tr>
</tbody>
</table>

Source: [http://www.imagisoft.com/equal/federalmidtermrates.html](http://www.imagisoft.com/equal/federalmidtermrates.html)
The interest rate that may be used is any interest rate that is not more than 120 percent of the federal mid-term rate for either of the two months immediately preceding the month in which the distribution begins.

Applicable account balance: The Ruling states that the account balance used to determine payments must be determined in a “reasonable manner based on the facts and circumstances.” The Ruling further gave the following example: For an IRA with daily valuations that made its first distribution on July 15, 2006, it would be reasonable to determine the yearly account balance when using the required minimum distribution method by basing it upon the value of the IRA from December 31, 2005 to July 15, 2006. For subsequent years, under the RMD method, it would be reasonable to use the value either on December 31 of the prior year or on a date within a reasonable period before that year’s distribution.

Life expectancy tables: The Ruling also changed the life expectancy tables that taxpayers used in determining their payments. Instead of choosing among Table UP 1984, 90 CM and Treas. Reg. §1.401(a)(9)-9 (all of which include both single and joint life factors), participants must now choose one of the following three life expectancy tables to determine distributions:

- **Uniform Lifetime Table.** This is a non-sex based table developed by the IRS to simplify minimum distribution requirements. The uniform lifetime table estimates joint survivorship, but does not use a beneficiary's age to determine the resulting life expectancy. This table can be used by all account owners regardless of marital status or selected beneficiary (see Table 6.2);
- **Single Life Expectancy Table** (Treas. Reg. § 1.401(a)(9)-9, Q&A-1). This is a non-sex based life expectancy table. This table does not use a beneficiary's age to calculate the account owner’s life expectancy. This table can be used by all account owners regardless of marital status or selected beneficiary. Choosing single life expectancy will produce the highest distribution of the three available life expectancy tables (see Table 6.3); and
- **Joint and Last Survivor Table** (Treas. Reg. § 1.401(a)(9)-9, Q&A-3). This is also a non-sex based life expectancy table for determining joint survivorship using the account owner’s oldest named beneficiary (see Table 6.4).

The number that is used for a distribution year is the number shown from the table for the employee’s (or IRA participant’s) age on his or her birthday in that year. This is known as the “applicable divisor period” (ADP).

**Calculating the Three Methods**

Assumptions:

- IRA account balance: $500,000
- Age of participant in distribution year: 50
- Age of Beneficiary (Spouse): 45
• 120 Federal Mid-term Rate (April 1 – April 30, 2017): 2.52%  

**Table 6.2**  
72(t) Annual Payments  
Uniform Lifetime Table (Age 50/45) $500,000 (Using a rate of 2.52%)  
Date: 4/1/2017

46.5 Years Life Expectancy  
$10,753 [$896/mo] Minimum Distribution Method  
$18,376 [$1,531/mo] Amortization Method  
$21,916 [$1,826/mo] Annuitization Method

**Account Balances and Distribution**

<table>
<thead>
<tr>
<th>Attn. Age</th>
<th>Life Exp.</th>
<th>Beginning Balance</th>
<th>Annual Payment</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
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<td>45.5</td>
<td>$490,684</td>
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<td>59</td>
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<td>$395,529</td>
</tr>
<tr>
<td>60</td>
<td>36.5</td>
<td>$395,529</td>
<td>$21,916</td>
<td>$383,580</td>
</tr>
</tbody>
</table>

**Table 6.3**  
72(t) Annual Payments  
Single Life Table (age 50/45) $500,000 (Using a rate of 2.52%):  
Date: 4/1/2017

34.2 Years Single Life Expectancy  
$14,620 [$1,218] Life Expectancy Method  
$21,986 [$1,832/mo] Amortization Method  
$21,916 [$1,826/mo] Annuitization Method
### Account Balances and Distributions

<table>
<thead>
<tr>
<th>Attn. Age</th>
<th>Life Exp.</th>
<th>Beginning Balance</th>
<th>Annual Payment</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>34.2</td>
<td>$500,000</td>
<td>$21,986</td>
<td>$490,614</td>
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<tr>
<td>51</td>
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<td>$480,991</td>
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<td>$480,991</td>
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<tr>
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<td>32.2</td>
<td>$471,125</td>
<td>$21,986</td>
<td>$471,125</td>
</tr>
<tr>
<td>53</td>
<td>31.2</td>
<td>$461,011</td>
<td>$21,986</td>
<td>$461,011</td>
</tr>
<tr>
<td>54</td>
<td>30.2</td>
<td>$450,642</td>
<td>$21,986</td>
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<td>$440,012</td>
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</tr>
<tr>
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<td>$429,114</td>
<td>$21,986</td>
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<td>24.2</td>
<td>$480,991</td>
<td>$21,986</td>
<td>$382,705</td>
</tr>
</tbody>
</table>

### Table 6.4
**72(t) Annual Payments**
Joint Life Table (Age 50/45) $500,000 (Using a rate of 2.52%):
Date: 4/1/2017

- 43.2 Years Joint Life Expectancy
- $11,574 [$965/mo] Life Expectancy Method
- $19,127 [$1,594/mo] Amortization Method
- $21,916 [$1,826/mo] Annuitization Method

### Account Balances and Distribution

<table>
<thead>
<tr>
<th>Attn. Age</th>
<th>Life Exp.</th>
<th>Beginning Balance</th>
<th>Annual Payment</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>50/45</td>
<td>43.2</td>
<td>$500,000</td>
<td>$21,916</td>
<td>$490,684</td>
</tr>
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<td>51/46</td>
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<td>$490,684</td>
<td>$21,916</td>
<td>$481,132</td>
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<tr>
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<td>41.2</td>
<td>$481,132</td>
<td>$21,916</td>
<td>$471,341</td>
</tr>
<tr>
<td>53/48</td>
<td>40.2</td>
<td>$471,341</td>
<td>$21,916</td>
<td>$461,302</td>
</tr>
<tr>
<td>54/49</td>
<td>39.2</td>
<td>$461,302</td>
<td>$21,916</td>
<td>$451,010</td>
</tr>
<tr>
<td>55/50</td>
<td>38.2</td>
<td>$451,010</td>
<td>$21,916</td>
<td>$440,460</td>
</tr>
<tr>
<td>56/51</td>
<td>37.2</td>
<td>$440,460</td>
<td>$21,916</td>
<td>$429,643</td>
</tr>
<tr>
<td>57/52</td>
<td>36.2</td>
<td>$429,643</td>
<td>$21,916</td>
<td>$418,553</td>
</tr>
<tr>
<td>58/53</td>
<td>35.2</td>
<td>$418,553</td>
<td>$21,916</td>
<td>$407,184</td>
</tr>
<tr>
<td>59/54</td>
<td>34.2</td>
<td>$407,184</td>
<td>$21,916</td>
<td>$395,529</td>
</tr>
<tr>
<td>60/55</td>
<td>33.2</td>
<td>$395,529</td>
<td>$21,916</td>
<td>$383,580</td>
</tr>
</tbody>
</table>

Distributions from Ages 59½ and 70

During this period of time, a participant of a Traditional IRA can choose to withdraw the entire balance in an IRA account or any amount as needed between ages 59½ and 70 without paying the 10% addition to tax discussed above. However, if the IRA participant chooses to distribute funds from his or her IRA during this time the rules will depend on whether the funds distributed are from deductible or non-deductible contributions.

Deductible Contributions

Under IRC § 408(d)(1) funds distributed from an IRA that were made up of deductible contributions will be included as taxable income and subject to ordinary income taxes. However, the distribution will not be subject to the 10% addition tax mentioned above.

**Example:** If Bob age 60, withdrew $25,000 from his IRA, the amount would be added to his income of $150,000 [IRC § 408(d)(1)]. Bob would pay income taxes on $175,000.

Non-deductible Contributions

When an IRA participant takes a distribution from his or her Traditional IRA, which includes non-deductible contributions, only the earnings attributable to such contributions will be taxable when distributions are made and the non-deductible contributions are recovered tax-free.

An exclusion ratio must be calculated by dividing the amount of total non-deductible contributions by the value of the individual retirement account(s) at the time the withdrawal is made. Under IRC § 408(d)(2) all individual retirement accounts owned by an individual must be aggregated in order to determine the exclusion ratio for the non-deductible contribution.

The resulting percentage, or exclusion ratio, is applied to the amount of the withdrawal to determine the portion that can be excluded from income taxation. In the case of withdrawals taken as annuity payments, the ratio remains the same until all non-deductible contributions have been withdrawn. With other forms of withdrawals, the ratio must be recalculated each time a withdrawal is made. This is accomplished by dividing the adjusted amount of non-deductible contributions (i.e., as reduced by the portion included in previous withdrawals) by the updated value of the individual retirement account(s) at the time of the withdrawal.

**Example:** Bob, age 50, takes an early retirement and rolls over his qualified retirement plan with a total value of $100,000, to his individual retirement account. Bob also had an existing IRA with a total of $78,000 of non-deductible contributions. Bob is looking to take a withdrawal from his IRA of $10,000. His exclusion ratio at that time was .4382 [$.78,000 (cumulative non-deductible contributions) divided by $178,000 (account value at time of withdrawal)]. Thus,
$4,382 of the withdrawal is non-taxable return of basis, and $5,618 is ordinary income. The following year, when the account has a value of $200,000, Bob takes another $10,000 withdrawal. This time the exclusion ratio is .3681. The numerator, the cumulative non-deductible contributions, must be reduced by the $4,382, which was distributed the prior year, so that the computation this time is $73,618 ($78,000-$4,382) divided by $200,000 (new value at time of withdrawal). Thus, the second $10,000 withdrawal represents $3,681 of tax-free basis recovery and $6,319 of ordinary income.

**Distributions from Age 70½**

Under IRC § 401(a)(9), amounts accumulated in a Traditional IRA, a Employee Pension (SEP), or a Savings Incentive Match Plan for Employees (SIMPLE) IRA) must be distributed according to required minimum distribution (RMD) requirements that are essentially the same as applicable to qualified retirement plans of employers.

**Required Minimum Distributions**

In 1987 the IRS issued a set of proposed regulations for implementation of the required minimum distribution rules under IRC § 401(a)(9). Although these proposed regulations were never formally finalized, they stood as the operative rules on this subject for over 13 years. In early 2001 the IRS and Treasury issued a new set of proposed regulations, substantially revising these rules. The new Treas. Regs, generally hailed as a major positive overhaul, were responsive to a number of comments received regarding the original rules, including most notably, complaints that they were inflexible and excessively complex. After receiving comments on the new proposed Regs, the Treasury issued them in final form, with some minor changes [T.D. 8987 (April 16, 2002)].

**Required Beginning Date (RBD)**

The fundamental rule for distribution of retirement plan benefits (and IRAs) provides that the entire interest of each employee (plan participant) must be distributed to such employee (participant) not later than the required beginning date [IRC § 401(a)(9)(A)].

For an IRA [IRC § 408(a)(6)], the term “required beginning date” (RBD) means April 1 of the calendar year following the calendar year in which the individual attains age 70 ½ [Treas. Reg. 1.408-8 Q & A -3].

However, in the case of a qualified retirement plan the RBD is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 ½ or the calendar year in which the employee retires. The rules for extending the required beginning date for employees qualified retirement plan do not apply to employees who are 5% or more owners of the company sponsoring the plan. For such persons, the required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70 ½. “Five percent ownership” means ownership of
more than 5 percent of the capital or profits of the employer \([\text{IRC} \, \text{§} \, 416(i)(1)(B)(i)(II)]\) or, if the employer is a corporation, more than 5% of the outstanding stock of the corporation or stock possessing more than 5% of the total combined voting power of the corporation \([\text{IRC} \, \text{§} \, 416(i)(1)(B)(i)(I)]\).

**Note:** A plan is permitted to provide that the required beginning date for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 70 ½ regardless of whether the employee is a five percent owner. Make sure you review your client’s Summary Plan of Description (SPD).

An IRA participant (employee) is deemed to attain age 70 ½ as of the date six (6) calendar months after the 70th anniversary of the participant’s birthday.

**Example 1:** Mr. Jones, born January 1, 1947, will turn 70 years old \((2017 \, - \, 1947 = 70)\) on January 14, 2017. Six months later, July 1, 2017, Mr. Jones will be 70 ½. Mr. Jones will be required to take his 2017 IRA required minimum distribution (RMD) by April 1, 2018, his required beginning date (RBD). Mr. Jones will also have to take his 2018 required minimum distribution (RMD) by December 31, 2018.

**Example 2:** Mrs. Jones was born on July 4, 1947, she will turn age 70 on July 4, 2017. Six months after July 4, 2017, which is January 4, 2018, Mrs. Jones will be 70 ½. Mrs. Jones is not required to take a 2017 required minimum distribution (RMD) because she didn’t turn 70 ½ until 2018. She is required to take her 2018 required minimum distribution (RMD) by April 1, 2019, her required beginning date (RBD). Mrs. Jones must take her 2019 required minimum distribution (RMD) by December 31, 2019.

The example above, illustrates that anyone attaining age 70 between January 1 and June 30 in a given year will turn 70 ½ in that same year. Also note that if an IRA participant does not take the RMD in the year age 70 ½ is attained, but waits until April of the following year, the IRA participant must take a second distribution by December 31 of that year.

**Calculating Required Minimum Distribution**

In general, the RMD is computed for each participant, based upon life expectancy, the idea being that distributions are spread ratably over a period projected to coincide with the remaining lifetime of the IRA participant (or the joint lives of the IRA participant and a designated beneficiary). Thus, the minimum payment is calculated based upon a number of years of life expectancy, determined from IRS actuarial tables. The value of the retirement plan assets, as of the beginning of each calendar year, beginning with the year in which age 70½ is attained, is divided by the applicable life expectancy to determine the minimum distribution for that year. The 1987 regulations required the use of Tables V and VI in Reg. §1.72-9 for determining the life expectancy divisor. Under the new Regs., only the new Uniform Lifetime Table discussed below, is used prior to the
death of the participant, except in cases where the designated beneficiary is a spouse more than ten years younger than the participant. In that case, the applicable distribution period will be that determined using the Uniform Life Table or the joint life expectancies of the participant and the spouse using the participant and the spouse’s birthdays in the distribution calendar year [Treas. Reg. 1.408(a)(9)-5, A-4(b)].

The RMD is recalculated each year, based upon the value of the account as of the last day of the previous calendar year, divided by the applicable life expectancy factor (see formula below).

Once the amount is determined it may be distributed at any time during the calendar year, in a single payment or any number of partial payments. With regard to the determination of the account value balance, it should be noted that even if the RMD for a given year is not made until December 31, the account value used in calculating the required minimum amount is the value as of December 31 of the previous calendar year. This date is used even for the year that the IRA owner turns 70½, when the first RMD is delayed until April 1 of the following year. In cases where the distribution for the age 70½ year is deferred until the first quarter of the following year (i.e., through April 1), the account balance used to determine the second distribution is calculated without subtracting from the account balance on the last day of the age-70½ year, any distribution made in the first quarter of the subsequent year to satisfy the RMD for the 70½ year [Treas. Reg. §401(a)(9)-5, Q&A-3(c)].

<table>
<thead>
<tr>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>This is the basic formula for calculating a required minimum distribution using the Internal Revenue Service life expectancy tables:</td>
</tr>
</tbody>
</table>
| \[
| \text{Account Balance, Prior 12/31} = \frac{\text{RMD in Dollars for Current Year}}{\text{Life Expectancy Factor}} \\
| \text{Account Balance, Prior 12/31} = \frac{\$500,000}{27.4} = \$18,248.18 \\
<table>
<thead>
<tr>
<th>\text{Uniform Life Expectancy}</th>
</tr>
</thead>
</table>

It is important to note that, although the concept of spreading out minimum payments based upon life expectancy would theoretically produce roughly equal amounts each year until the account is exhausted at death, annual distributions can actually vary widely from year to year, since they are based upon continually changing current market values of the remaining asset pool (see Table 6.5).
Penalties for Failure to Make RMDs

Under IRC § 4974(a), once the participant reaches his/her RBD, RMDs are required to commence, if none are made, or if they total less than the required minimum in any year, a penalty excise tax of 50% is imposed, computed as 50% of the amount by which the RMD exceeds the amount actually distributed.

If an IRA participant does not take the proper RMD, they will need to complete IRS Form 5329 and attach a letter of explanation to their tax return for that year. Up until a couple of years ago, you were required to also send in a check for the amount of the penalty. This is no longer required. If the IRS decides not to grant a waiver, they’ll send a bill.

Note: If an amount in excess of the RMD is distributed for any year, the excess may not be carried forward to reduce the minimum distribution as calculated for any future year [Treas. Reg. §401(a)(9)-5,Q&A-2].

IRS Life Expectancy Tables

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 instructed the Secretary of Treasury to update the life expectancy tables used for purposes of the required minimum distribution rules to reflect current life expectancy. In accordance with that instruction, the final regulations have adopted new tables incorporating improved mortality projections through 2003 [Treas. Reg. §1.401(a)(9)-9]. This has resulted in a slight increase in the life expectancy based divisors, which will produce lower required minimum distribution amounts.

Table 6.5
RMD Calculation Account Balances and Required Minimum Distributions*

<table>
<thead>
<tr>
<th>Age</th>
<th>Life Expectancy (ADP)</th>
<th>Required Minimum Distribution</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
<td>27.4 (Birthday on or before June 30th)</td>
<td>$18,248.18</td>
<td>$501,751.82</td>
</tr>
<tr>
<td>71</td>
<td>26.5</td>
<td>$18,934.03</td>
<td>$502,887.86</td>
</tr>
<tr>
<td>72</td>
<td>25.6</td>
<td>$19,644.06</td>
<td>$503,359.32</td>
</tr>
<tr>
<td>73</td>
<td>24.7</td>
<td>$20,378.92</td>
<td>$503,114.77</td>
</tr>
<tr>
<td>74</td>
<td>23.8</td>
<td>$21,139.28</td>
<td>$502,100.08</td>
</tr>
<tr>
<td>75</td>
<td>22.9</td>
<td>$21,925.77</td>
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<tr>
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<td>22.0</td>
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<td>$497,529.64</td>
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<td>19.5</td>
<td>$25,096.81</td>
<td>$483,866.51</td>
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<td>80</td>
<td>18.7</td>
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<tr>
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<td>$469,772.43</td>
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<td>17.1</td>
<td>$27,472.07</td>
<td>$461,091.26</td>
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<tr>
<td>83</td>
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<td>$28,287.81</td>
<td>$451,247.10</td>
</tr>
<tr>
<td>Age</td>
<td>Life Expectancy (ADP)</td>
<td>Required Minimum Distribution</td>
<td>Balance</td>
</tr>
<tr>
<td>-----</td>
<td>----------------------</td>
<td>------------------------------</td>
<td>---------</td>
</tr>
<tr>
<td>84</td>
<td>15.5</td>
<td>$29,112.72</td>
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<td>13.4</td>
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<td>$400,449.62</td>
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<td>$368,255.57</td>
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<td>$32,303.12</td>
<td>$350,682.68</td>
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<td>$32,470.62</td>
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<td>$251,627.13</td>
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<td>$31,065.08</td>
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<td>$29,507.96</td>
<td>$188,378.84</td>
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<tr>
<td>99</td>
<td>6.7</td>
<td>$28,116.25</td>
<td>$167,797.75</td>
</tr>
<tr>
<td>100</td>
<td>6.3</td>
<td>$26,634.56</td>
<td>$147,875.10</td>
</tr>
</tbody>
</table>

*All distributions are assumed to be taken at the end of the year. Rate of growth projected is 4%. For additional information see IRS Publication 590*

**Uniform Lifetime Table**

The divisor for the required minimum distribution computation during the IRA participant’s lifetime using the Uniform Lifetime Table (IRS Publication 590-B) can be determined from the prescribed table without regard to the beneficiary’s age (an assumed 10-year age difference between the account owner and the beneficiary is built into the table). The divisor is also referred to as the applicable distribution period (ADP) (see Table 6.6). **Note:** Since the required minimum distribution (RMD) rules apply to qualified plan participants as well as IRA owners, the actual “age” column heading in the Regs. refers to the age of the “employee” participant. However, the regulations specifically state that the term “employee” is also intended to refer to an IRA participant- owner.

**Calculating RMDs Using the Uniform Lifetime Table**

As stated above, the minimum required annual distribution is based upon a calculation intended to have the account fully liquidated ratably over a period (sometimes referred to as the “spread period” or “distribution period”) based primarily upon the IRA participant’s remaining life expectancy. However, IRC § 401(a)(9) allows the spread period to be based not only on the participants life expectancy, but upon the joint and survivor life expectancy of the IRA participant and a designated beneficiary. The implementation of this joint life expectancy spread period was spelled out in detail in the 1987 regulations. These regulations contain detailed rules concerning parameters and procedures for the designation of the beneficiary for purposes of determining the joint life
expectancy spread period. Once the beneficiary is identified, the payout spread period (the divisor in the annual required minimum distribution computation) is determined from an IRS-promulgated joint life expectancy table, using the ages of the participant and the beneficiary. These rules were criticized as unnecessarily complex, and they were substantially revised in the 2002 final version of the regulations.

The revised final regulations, published in April 2002, incorporate a new “Uniform Lifetime Table,” using updated mortality data, and based upon the joint life expectancy of the participant and another person 10 years younger. Since 2003, this new table is to be used in all cases to determine the joint life expectancy payout period, regardless of whether or not a beneficiary has in fact been designated, and regardless of the actual age of the beneficiary [Reg. §1.401(a)(9)-5,Q&A-4(a)]. This was a major change from the regime of the 1987 proposed regulations, under which the payout period depended upon the actual age of the beneficiary. However, as discussed below, if the sole designated beneficiary is the participant’s spouse, then their actual joint life expectancies may be used, even if the spouse is more than 10 years younger [Treas. Reg. §1.401(a)(9)-5,Q&A-4(b)]. This change from the method required under the 1987 regulations resulted in substantial simplification and potential liberalization in many situations.

**Table 6.6**

The Uniform Lifetime Table

<table>
<thead>
<tr>
<th>Age</th>
<th>Life Expectancy Factor</th>
<th>% of Account</th>
<th>Age</th>
<th>Life Expectancy Factor</th>
<th>% of Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
<td>27.4</td>
<td>3.65%</td>
<td>93</td>
<td>9.6</td>
<td>10.42%</td>
</tr>
<tr>
<td>71</td>
<td>26.5</td>
<td>3.77%</td>
<td>94</td>
<td>9.1</td>
<td>10.99%</td>
</tr>
<tr>
<td>72</td>
<td>25.6</td>
<td>3.91%</td>
<td>95</td>
<td>8.6</td>
<td>11.63%</td>
</tr>
<tr>
<td>73</td>
<td>24.7</td>
<td>4.05%</td>
<td>96</td>
<td>8.1</td>
<td>12.35%</td>
</tr>
<tr>
<td>74</td>
<td>23.8</td>
<td>4.20%</td>
<td>97</td>
<td>7.6</td>
<td>13.16%</td>
</tr>
<tr>
<td>75</td>
<td>22.9</td>
<td>4.37%</td>
<td>98</td>
<td>7.1</td>
<td>14.08%</td>
</tr>
<tr>
<td>76</td>
<td>22.0</td>
<td>4.55%</td>
<td>99</td>
<td>6.7</td>
<td>14.93%</td>
</tr>
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<td>115 &amp; Over</td>
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</tr>
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</table>
Using the Joint Life Table

If the sole designated beneficiary is the IRA participant’s spouse, then, as was the case under the 1987 proposed Regs., their actual joint life expectancies may be elected, even if the spouse is more than 10 years younger [Treas. Reg. §1.401(a)(9)-5,Q&A-4(b)]. Since it is likely that in most instances the IRA beneficiary is the spouse of the IRA participant, and most married couples are not more than 10 years apart in age, the revised regulations benefit most couples who desire the lowest possible required minimum distribution. This is because the now-mandated Uniform Lifetime Table uses a joint life expectancy based upon a 10-year age difference between the account owner and the beneficiary, whereas under the 1987 Regs., the actual joint life expectancies had to be used.

Moreover, if the beneficiary/spouse is more than ten years younger than the participant, a joint life table using the actual age of the spouse/beneficiary may be elected. This, of course, represents a substantial advantage when the spouse is the beneficiary. If the spouse is more than 10 years younger than the participant the spread period can be increased based upon the spouse’s actual age, but if the spouse is less than 10 years younger, the Uniform Lifetime Table can be used, which assumes that the beneficiary is a full 10 years younger (see Table 6.7).

| Table 6.7 |
| IRS Joint Life and Last Survivor Expectancy Table ¹ |

<table>
<thead>
<tr>
<th>Age²</th>
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<tr>
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<td>53</td>
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<tr>
<td>52</td>
</tr>
<tr>
<td>51</td>
</tr>
</tbody>
</table>

1 This is a partial table. For the complete table, please refer to IRS Publication 590.
2 For account owners who turn 70 between January and June, use the age 70 life expectancy factor to calculate the RMD. For account owners who turn 70 between July and December, use the age 71 life expectancy factor.
(Use this table for calculating lifetime RMDs from IRAs and retirement plan accounts when the spouse beneficiary is more than 10 years younger.)

**Example:** Jessica is a 72 year old IRA participant. Her husband, Jeff, is the sole beneficiary on her account. Jeff is 60 years old. On December 31 of last year, Jessica’s ending account balance was $262,000. To calculate her RMD for this year, she divides $262,000 by the life expectancy factor of 27 years. Her distribution amount is $9,703.70.

<table>
<thead>
<tr>
<th>Account balance</th>
<th>/</th>
<th>Life expectancy factor</th>
<th>=</th>
<th>RMD</th>
</tr>
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<tbody>
<tr>
<td>$262,000</td>
<td></td>
<td>27</td>
<td></td>
<td>$9,703.70</td>
</tr>
</tbody>
</table>

**Determination of Marital Status**

The regulations clarify that for lifetime distributions, the marital status of the IRA participant is determined on January 1 each year. Divorce or death after that date is disregarded until the next year. Further, a change in beneficiary due to the spouse’s death is not recognized until the following year.

**Qualified Charitable Distributions from IRAs**

For the past nearly decade, the rules allowing for tax-free Qualified Charitable Distributions (QCDs) directly from an IRA to a charity have been on-again, off-again, a part of the infamous Tax Extenders that would lapse and be reinstated every other year. But all that changed when on December 18, 2015, President Barrack Obama signed into law, the *Protecting Americans From Tax Hikes Act (PATH) of 2015*, which provided a provision (Part 2, Section 112) in the law that made permanent the IRA Qualified Charitable Distribution, retroactive to January 1, 2015 and making it easier to engage in proactive charitable giving strategies that help to minimize the tax bite of an IRA’s Required Minimum Distribution (RMD) obligations.

**Background**

The IRA charitable rollover provision which is contained in IRC § 408(d)(8), as created under Section 1201 of the Pension Protection Act of 2006, provides an annual exclusion from gross income up to $100,000 for “qualified charitable distributions” from an IRA, thereby removing the multitude of potential negative tax drawbacks traditionally associated with funding charitable contributions with IRA withdrawals. Thus, individuals qualifying for IRA charitable rollover treatment (who must have reached age 70 ½) wishing to make distributions from an IRA to charity can do so, to the extent of $100,000 per year without the risk of any additional tax burden. Of course, because it is excluded
from gross income, a qualified charitable deduction (QCD) from an IRA does not qualify
for a charitable income tax deduction; otherwise, there would be the double benefit of
income exclusion and a charitable contribution deduction. A QCD is taken into account
for purposes of the annual required minimum distribution requirement to the same extent
the distribution would have been taken into account under such rules had the distribution
been made to the account holder. As a result, a donor can distribute his/her entire annual
required minimum distribution to charity without any of such amount being subject to
tax. Where a distribution to charity does not qualify as a QCD, however, the amount
distributed is taxed as if it were received by the account holder and then contributed to
the charity under rules that apply in such a case without regard to the IRA charitable
rollover provision under IRC § 408(d)(8).

Requirements for a QCD

There are six requirements for an IRA distribution to qualify as a QCD under the IRA
charitable rollover provision. They are as follows:

- **IRA accounts only.** The distribution must be made from an IRA. For this purpose,
  Simplified Employee Plans (SEPs) and Savings Incentive Match Plans for
  Employees (SIMPLE plans), which are basically IRAs that receive employer
  contributions, as well as IRC §§ 403(b) and 401(k) plans, profit-sharing plans,
  and pension plans, do not qualify under the IRA charitable rollover provision.
  Many individuals over 70 ½ years old have large IRA balances attributable to
  rollovers from retirement accounts maintained at their former employers, which
  can be used to make distributions to charity. Where applicable, individuals over
  70 ½ years old who do not have IRAs can take advantage of the IRA charitable
  rollover provision by, for example, transferring funds from an existing IRC §
  401(k) plan into a newly established IRA. Generally, the exclusion for QCDs is
  available for distributions from any type of IRA (including a Roth IRA described
  in IRC § 408A and a deemed IRA described in IRC § 408(q)) that is neither an
  ongoing SEP IRA described in IRC § 408(k) nor an ongoing SIMPLE IRA
described in IRC § 408(p). For this purpose, a SEP IRA or a SIMPLE IRA is
treated as ongoing if it is maintained under an employer arrangement under which
an employer contribution is made for the plan year ending with or within the IRA
owner's taxable year in which the charitable contributions would be made;

- **Eligible recipients.** The recipient organization must be described in IRC §
  170(b)(1)(A), which generally includes organizations commonly referred to as
  “public charities,” such as churches, hospitals, museums, and educational
  organizations. Donor-advised funds (DAFs) operated by public charities, and
  supporting organizations, while described in IRC § 170(b)(1)(A), are specifically
  excluded as eligible recipients of IRA charitable rollover distributions, such that
distributions from IRAs to such entities, including, for example, a DAF sponsored
by a community foundation or a hospital foundation formed as a supporting
organization, do not constitute a QCD. Also excluded are split-interest trusts, such
as charitable remainder and lead trusts, and private non-operating foundations, as
such entities are not described in IRC § 170(b)(1)(A);
• **IRA account owner must be at least age 70 ½.** The distribution must be made on or after the date that the IRA account holder attains age 70 ½. Similarly, the exclusion from gross income for QCDs is available for distributions from an IRA maintained for the benefit of a beneficiary after the death of the IRA owner if the beneficiary has attained age 70 ½ before the distribution is made;

• **Distributions must be made directly to charity.** The distribution from the IRA to the charity must be made “directly by the trustee,” such that the distribution must be made payable directly from the IRA account to the charity. If a check is made payable to the IRA account owner and then endorsed over to the charity, it will not qualify. Under IRS Notice 2007-7, Q&A-41, it is permitted for the check from an IRA is made payable to a charitable organization described in IRC § 408(d)(8) and delivered by the IRA owner to the charitable organization, the payment to the charitable organization will be considered a direct payment by the IRA trustee to the charitable organization;

• **The distribution to charity must otherwise be fully deductible as charitable contributions.** A distribution to a charity will only qualify as a QCD if the “entire distribution would be allowable under IRC § 170” as a charitable deduction. Thus, any quid pro quo benefit received by the account holder in return for the distribution, such as the FMV of a dinner or other benefit that is not disregarded under IRC § 170, disqualifies the entire distribution, not just the benefit portion, from IRA charitable rollover treatment. The requirement that the entire distribution be allowable as a charitable deduction also prevents the funding of a pooled income fund or a charitable gift annuity from an IRA account from being considered a QCD, notwithstanding that the charity receiving the distribution is a public charity under IRC § 170(b)(1)(A). Further, under IRC § 170(f)(8), no charitable deduction is allowed for any contribution of $250 or more, unless the donor obtains a contemporaneous written acknowledgement, which must disclose the value of any goods or services provided by the charity in return for the contribution. Thus, to constitute a QCD, the donor must obtain a written acknowledgement indicating that no goods or services were received in return for the contribution. When making a distribution from an IRA for which charitable rollover treatment is sought, donors will be best served by first advising the charity that:
  o A distribution will be made from the donor's IRA account to the charity, which is intended to constitute a QCD under IRC § 408(d);
  o No goods, services, or benefits of any kind are to be provided by the charity to the donor or any other party in consideration for the distribution; and
  o Upon its receipt of the distribution, the charity must provide an acknowledgement to the donor, acknowledging the amount of the distribution and that no goods, services, or benefits of any kind were or will be provided to the donor or any other party in consideration for the distribution.

• **Distribution must otherwise be included in gross income.** The ordering rules of IRC § 408(d)(8)(D) explicitly require that any QCD from an IRA is deemed to come from the taxable portion of the account first (as opposed to the usual pro-
rata rule), which actually helps to ensure the most favorable treatment. In addition, all IRA accounts are aggregated together to determine the total taxable amount that is potentially eligible for a (pre-tax) QCD. Thus, only the taxable portion of any IRA distribution can qualify as a QCD. Notably, to the extent that a QCD uses up all available pre-tax funds from all IRAs, and now only after-tax dollars remain available, a QCD of after-tax dollars from an IRA will be eligible for a charitable deduction under IRC § 170(b), as though the after-tax funds were simply withdrawn in a non-taxable distribution and subsequently donated directly to the charity would also be entitled to a charitable income tax deduction. This would be the case, for example, for a Roth IRA, where a distribution that would otherwise not be taxable, as is generally the case, is distributed directly to charity. Where, however, a distribution from a Roth IRA would be taxable because it is made within the five-taxable-year period, the distribution can, in such a case, constitute a qualified charitable distribution provided all other requirements for such treatment are met, including the donor attaining age 70 ½.

Let’s examine a couple of examples:

**Example 1:** Bob, who is over 70 ½ years old, has an IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. The entire IRA balance is distributed directly to a qualified charitable organization, for which Bob receives no benefit in return. But for the IRA charitable rollover provision, the entire distribution of $100,000 would be includable in Bob’s gross income. Accordingly, under the IRA charitable rollover provision, the entire distribution of $100,000 is allowed as a QCD. No amount is included in Bob’s gross income as a result of the distribution and the distribution is not taken into account in determining the amount of Bob’s charitable deduction for the year.

**Example 2:** Mary, who is over 70 ½ years old, has an IRA with a balance of $100,000, consisting of $20,000 of non-deductible contributions and $80,000 of deductible contributions and earnings. In a distribution to a qualified charitable organization, $80,000 is directly distributed from the IRA, for which Mary receives no benefit. But for the IRA charitable rollover provision, a portion of the distribution from the IRA would be treated as a nontaxable return of non-deductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by the ratio of the non-deductible contributions to the account balance ($20,000/$100,000). Accordingly, under pre-IRA charitable rollover law, $64,000 of the distribution ($80,000 minus $16,000) would be includable in Mary’s income. Under the IRA charitable rollover provision, notwithstanding the pre-IRA charitable rollover tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includable in gross income (but for the IRA charitable rollover provision) if all amounts were distributed from the IRA. The total amount that would be includable in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the IRA charitable rollover provision, the entire $80,000
distributed to the charitable organization is treated as includable in income and is a QCD. No amount is included in Mary’s income as a result of the distribution and the distribution is not taken into account in determining the amount of Mary’s charitable deduction for the year. In addition, the $20,000 of the amount remaining in the IRA is treated as Mary’s non-deductible contributions.

Now that QCDs are a permanent element of the tax law, and likely to remain in place for the foreseeable future, advisors have proactive tax planning opportunities—assuming all the requirements are met.

**Qualified Longevity Annuity Contracts**

In July 2014, the U.S. Treasury Department removed a significant impediment to the ability of IRA participants (and qualified plan participants) to balance their use of annuities and other investments in their retirement savings arrangements, issuing final regulations that generally allow those individuals to bypass required minimum distribution (RMD) rules. The regulations create a qualified longevity annuity contract, or “QLAC,” a deferred annuity under which the amount of annuity payments is locked in at purchase, and those payments begin at any age up to age 85. These annuities are also referred to as deferred income annuities, or “DIAs.”

**QLAC Concept**

The basic concept of a longevity annuity is that, like an immediate annuity, a lump sum payment is made in exchange for guaranteed payments (typically for life) in the future. The difference is that while the lifetime payments from a single premium immediate annuity (SPIA) start immediately – as the name implies – with a QLAC the onset of those payments is deferred until some point in the future (the term “Deferred Income Annuity” [DIA]).

**Example:** A 65-year-old couple today could put $100,000 into a SPIA and get (level) payments of almost $6,000/year for life, but if the couple was willing to wait until age 85 to get the first payment, the subsequent payments would be nearly $32,000/year for life instead! The good news of this approach is that the payments in the later years are dramatically larger with a QLAC than an immediate annuity. The bad news, of course, is that you have to wait 20 years to get the first check!

Even when adjusting for the waiting period and the time value of money, though, the reality is that in the long run (for those who actually do live a long time), a longevity annuity’s payments provide a better internal rate of return (IRR) than a SPIA. In other words, while the longevity annuity buyer is at risk for a greater loss in the early years (since it may take 20 years just to get the first payment), those greater payments pay off in the long run with a superior implied return (for those who actually live long enough to see them).
QLAC Rules

The Treasury issued Proposed Regulations 1.401(a)(9)-6 in 2012, and the Regulations were finalized July 2014. The basic approach of the Regulations is to define a “Qualified” Longevity Annuity Contract (QLAC), and then declare that any longevity annuity that meets the QLAC requirements will not be in conflict with the RMD rules.

To be eligible as a QLAC, a longevity annuity must meet the following requirements:

- Over their lifetime, individuals cannot allocate more than $125,000 of their qualifying retirement plan [IRC §§ 401(a)/(k), 403(b), governmental IRC § 457(b)] and IRA (traditional; not Roth or inherited IRAs) savings to QLACs;

- Additionally, no more than 25% of the participant’s account in any one qualifying retirement plan may be allocated to purchase one or more QLACs. This limit also applies to Traditional IRAs; however, rather than applying to each separate IRA, the limit applies to the aggregate of the individual IRA. Unlike Roth IRAs, Roth accounts within retirement plans are eligible for QLACs because they are also subject to required minimum distribution (RMD) requirements; and

- The 25% limit applies differently to plans and to IRAs. Under a plan the 25% limit applies to the most recent valuation of the plan, and under an IRA it applies to the prior 12/31 aggregated IRA balance. In both cases the value includes the present value of any previously purchased QLAC or NQLAC under the plan or the IRA. The plan account value is also adjusted for any subsequent contributions or distributions. It is unclear whether this same adjustment applies to the 12/31 IRA value.

QLACs generally cannot include surrender, withdrawal, or commutation features. However, contract provisions permitting a partial or total surrender to correct an excess premium or purchase payment are not considered to violate this restriction. The stated reason for this general prohibition on cashability is to maximize the amount of future benefit actually purchased, especially since these contracts are excluded from annual required minimum distribution (RMD) calculations and distributions. If individuals want to purchase a similar contract with more cashability, they can still purchase a NQLAC. However, unless they are certain they will have sufficient remaining assets within the plan to cover required minimum distributions (RMDs) for the plan or IRA, taking into account the value of the NQLAC in the required minimum required distribution (RMD) calculations, income payments under the NQLAC should commence no later than when an individual attains age 70½.

Death benefits are permitted both before and after income payments commence, and such benefits are not considered to violate the limitations on cashability, provided that the death benefits fit within specific QLAC requirements.

Death benefits prior to when income payments begin generally are limited to a return of the original premium (ROP), with no interest credited. Comments on the Treasury
Department’s earlier proposed regulations had noted the importance of this return of the original premium (ROP) feature to encouraging individuals to consider the QLAC options. A QLAC also may include a return of premium death benefit that applies after income payments commence, upon the death of the annuitant (and, if applicable, spousal joint annuitant).

QLACs also can include payments to joint annuitants, whether or not the joint annuitant is the individual’s spouse. Such payments, however, also should be life contingent, and thus the annuity cannot include the minimum guaranteed annuity period component (“period certain annuity” or “installment refund”). Additionally, if the joint annuitant is not the individual’s spouse, and if the QLAC includes a return of original premium death benefit prior to the commencement of income payments, then the regulations apply new limits to the non-spousal survivor annuity benefit. Additionally, a QLAC payable to a non-spouse beneficiary upon the death of the owner can include either a joint life income, or a return of original premium death benefit for income payments, but not both.

**Additional Considerations**

Plan sponsors are generally responsible for the selection or authorization of any investments under the plan, and that includes QLACs and NQLACs. In the case of a plan subject to fiduciary rules under Title I of ERISA, that selection or authorization is a fiduciary decision. Even for non-ERISA plans, plan sponsors or fiduciaries generally must authorize the offering of either QLACs or NQLACs to plan participants.

If a plan does not permit the offering of these contracts, then the plan account balance is disregarded in determining a participant’s eligibility for QLAC or NQLAC purchases under other plans or Traditional IRAs.

A QLAC or an NQLAC can either stand alone as an Individual Retirement Annuity, or be held under an IRA account. Similarly, in the case of employer plans, the contract can be held under the plan as a stand-alone annuity under IRC §§ 403(a), 403(b), or 457(b), as applicable, or it can be held under a trust or custodial agreement under a IRC § 401(a) IRC § 401(k) or IRC § 457(b) plan. A QLAC generally cannot be held under a IRC § 403(b)(7) custodial agreement.

If the QLAC or NQLAC is obtained from the plan service provider, and the employer later replaces that service provider with another service provider, the QLAC or NQLAC contract will remain with the issuing provider. However, the plan may have the option of:

- Retaining the contract as a stand-alone qualifying plan investment;
- Distributing the contract out of the plan to the participant (if the participant satisfies applicable distribution requirements); or
- If it is issued under a group annuity contract, and if the new plan is a 401(a) or 457(b) plan that would accept it, transferring the ownership of the group contract to the new plan.
If the plan is an ERISA plan, unless the contract is distributed to the participant, the plan will need to continue to maintain plan records of the contract(s) and, where applicable, incorporate relevant information into the documents and reports.
Chapter 6
Review Questions

1. To discourage IRA participants from taking distributions from their IRAs prior to age 59½, the IRS imposes a tax penalty of what percent?

   ( ) A. 6%
   ( ) B. 10%
   ( ) C. 25%
   ( ) D. 50%

2. Which IRS form is used to report the RMD penalty and to request a waiver?

   ( ) A. IRS Form 5329
   ( ) B. IRS Form 8608
   ( ) C. IRS Form 8880
   ( ) D. IRS Form 8888

3. What is the maximum amount allowed under IRC § 72(t)(2)(F) for a “first time” homebuyer?

   ( ) A. $1,000
   ( ) B. $10,000
   ( ) C. $20,000
   ( ) D. $100,000

4. Which of the following IRC Sections compels certain annual required minimum distributions (RMDs) from an IRA beginning at age 70½, or if earlier, at death?

   ( ) A. IRC § 408A
   ( ) B. IRC § 72(t)(2)
   ( ) C. IRC § 401(a)(9)
   ( ) D. IRC § 72(t)(1)

5. What is the penalty imposed for failure to take an RMD?

   ( ) A. 6% of the amount not taken
   ( ) B. 10% of the amount not taken
   ( ) C. 25% of the amount not taken
   ( ) D. 50% of the amount not taken
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CHAPTER 7

IRA BENEFICIARY PLANNING

Overview

This chapter will provide an in-depth review of the required minimum distributions (RMDs) after the IRA participant dies. It will review the importance of beneficiary planning for IRAs and other retirement plans, as well as review the various types of beneficiaries and the tax rules and regulations under IRC § 401(a)(9).

Learning Objectives

Upon completion of this chapter, you will be able to:

- Utilize proper planning for the beneficiary of an IRA and other retirement plans;
- Explain the differences between Per Stirpes and Per Capita;
- Define a designated and a non-designated beneficiary;
- Determine the qualifications of a designated beneficiary; and
- Apply distribution rules to various beneficiaries upon the death of the IRA participant, and prior to or after the required beginning date (RBD) of the participant.

IRA Beneficiary Planning

Naming beneficiaries of an IRA and other qualified retirement plan assets remains an area that is fraught with (often needless) complications. First, it is so important that your clients name their beneficiaries prior to death, on a beneficiary designation form. Secondly your clients should not only name a primary beneficiary but also a contingent beneficiary and also review the uses of “per stirpes” and “per capita.”

When an IRA participant names a beneficiary (other than their estate), the beneficiary designation named generally supersedes the participant’s will in determining to whom assets in the IRA are transferred. Upon the participant’s death, these beneficiary designations override bequests the participant made in his/her will or trust and the assets transfer directly to the named beneficiary.
Changing Beneficiaries

During the IRA participant’s lifetime he/she may change or revoke IRA beneficiary designations at any time. As the advisor, you should review your clients’ beneficiary forms annually. Things change in life, and you’ll want to make sure your clients have updated their beneficiary selection with marriages, divorce, births, and deaths.

Types of Beneficiaries

There are two basic types of beneficiaries:

- Primary beneficiary; and
- Contingent beneficiary.

Primary Beneficiary

A “primary beneficiary” is the IRA participant’s first choice for a beneficiary. In the event of the participant’s death, the first person who can claim the assets is the primary beneficiary. An IRA participant can have multiple primary beneficiaries in some cases. The participant may specify a percentage (the recommended way) or dollar amount (not recommended) that is to be paid to each beneficiary.

The participant may also indicate whether a beneficiary’s share will end if he/she predeceases the participant or if that share will pass to his or her children. This situation typically comes into play when the participant designates equal shares to “all my children.” These explanations of the more common designations should be reviewed for state variations, since terminology and definitions may differ somewhat from state to state.

- All My Children – If an IRA participant uses this term or names each child specifically, the IRA assets will be divided among the participant’s surviving children only. If one of the participant’s children dies before the participant, the remaining children will share equally in the deceased child’s portion.

Contingent Beneficiary

A “contingent beneficiary” is used as a backup. In the event that there are no living primary beneficiaries, the contingent beneficiary claims the assets of the IRA.

Example: A husband picks his wife as the primary beneficiary. She would receive any assets at his death. However, the husband and wife are killed together (at the same time) in an auto accident. Therefore, the IRA assets will go to a contingent beneficiary.
**Note:** As the advisor, you should check every IRA account you manage and make sure that the account has an updated primary and contingent beneficiary named on the account.

**Per Stirpes vs. Per Capita**

There are different strategies an IRA participant can use to ensure the pass-through of assets to second-generation beneficiaries upon his or her death. The following example explains the use of per stirpes and per capita.

It is important to note that if the IRA participant does not make a *per stirpes* or *per capita* election then the funds in the account will be distributed to all surviving primary beneficiaries.

**Per Stirpes**

If a beneficiary designation is made “*per stirpes*” and that beneficiary dies leaving children of his/her own, the deceased beneficiary’s share of the death benefit would be paid to his/her living children (see Illustration 7.1).

**Illustration 7.1**  
**Example of a Per Stirpes Designation**

<table>
<thead>
<tr>
<th>Name</th>
<th>SSN</th>
<th>Relationship</th>
<th>DOB</th>
<th>% of Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary</td>
<td>John Doe,</td>
<td>Son</td>
<td>XX-XX-XXX</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>Per Stirpes</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

It is important to note that if the IRA participant wants to use a per stirpes designation, first he/she must check to see if the trustee/custodian of the IRA will allow, and if so, the designation must include the words “per stirpes” after the beneficiary(ies) name.

**Per Capita**

Most IRAs are automatically set-up to distribute assets “*per capita*” to the beneficiaries designated on the IRA beneficiary designation form. If for example, an IRA participant designated his/her two children as primary beneficiaries and one of those children died prior to the IRA participant, the remaining child would inherit 100 percent of the participant’s IRA and the children of the deceased child would inherit none of the proceeds (see Illustration 7.2).
Illustration 7.2
Example of a Per Capita Designation

<table>
<thead>
<tr>
<th>Name</th>
<th>SSN</th>
<th>Relationship</th>
<th>DOB</th>
<th>% of Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary</td>
<td>John Doe</td>
<td>XXX-XX-XXX</td>
<td>Son</td>
<td>XX-XX-XXX</td>
</tr>
<tr>
<td>Primary</td>
<td>Jane Doe</td>
<td>XXX-XX-XXX</td>
<td>Daughter</td>
<td>XX-XX-XXX</td>
</tr>
</tbody>
</table>

If John predeceases the IRA participant, Jane would inherit 100 percent of the IRA.

| Primary   | Jane Doe  | XXX-XX-XXX   | Daughter  | XX-XX-XXX    | 100%         |

**Designated Beneficiary Rules**

As a general rule, a “designated beneficiary” is an individual who is designated as a beneficiary under the plan, either by the terms of the plan, or if the plan so provides, by the affirmative election of the participant [IRC § 401(a)(9)(E); Treas. Reg. 1.401(a)(9)-4, Q&A-1].

Only individuals may be designated beneficiaries for purposes of the distribution rules. A legal “person” that is not an individual, such as the “estate” of the participant or a charitable organization, may not be a designated beneficiary. If, a person other than an individual is designated as a beneficiary of a participant’s IRA, the participant will be treated as not having a designated beneficiary [Treas. Reg. 1.401(a)(9)-4, Q&A 3].

A designated beneficiary need not be specified by name in the IRA or by the participant in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the IRA as of the date the beneficiary is determined. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, as of the date the beneficiary is determined, to identify the class member with the shortest life expectancy (the eldest). However, as discussed above, the fact that a participant’s interest under an IRA passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless the individual is properly designated as a beneficiary under the plan [Treas. Reg. 1.401(a)(9)-4, Q&A-1].

If there are two or more beneficiaries (multiple beneficiaries), only the oldest beneficiary will be treated as a designated beneficiary for purposes of determining the applicable distribution period (ADP) unless each beneficiary is entitled to a separate share or a separate account [Treas. Reg. 1.401(a)(9)-5, Q&A-7(a)1].
If there are two or more (multiple) beneficiaries, and one of the beneficiaries is not an individual, the participant will be treated as not having any designated beneficiary unless the non-individual beneficiary is entitled to a separate share or a separate account [Treas. Reg. 1.401(a)(9)-5, Q&A-7(a)(2)].

A separate account in an IRA is a portion of a participant’s benefit determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a pro-rata basis in a reasonable and consistent manner between such portion and any other benefits. [Treas. Reg. 1.401(a)(9)-8, Q&A-3]. The amounts of each such portion of the benefit will be separately determined for purposes of determining the amount of the minimum required distribution [Treas. Reg. 1.401(a)(9)-8, Q&A-3].

Once the separate accounts are actually established, the separate accounting can provide for separate investments for each separate account under which gains and losses from the investment of the account are allocated only to that account, or investment gains and losses can continue to be allocated among the separate accounts on a pro-rata basis. A separate accounting must allocate any post death distributions to the separate account of the beneficiary receiving that distribution [Treas. Reg. 1.401(a)(9)-8, Q&A-3].

**Date to Determine the Designated Beneficiary**

In order to be a designated beneficiary, an individual must be a beneficiary as of the date of the IRA participant’s death. The IRA participant’s designated beneficiaries will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the IRA participant’s death (known as the “beneficiary finalization date”). Accordingly, any person who was a beneficiary as of the date of the IRA participant’s death, but is not a beneficiary as of September 30 of the calendar year following the calendar year of the IRA participant’s death (either because the person disclaimed entitlement to the benefit in favor of another beneficiary or because the person received the entire benefit to which the person is entitled before that date) is not taken into account in determining the IRA participant’s designated beneficiary for purposes of determining the distribution period for minimum required distributions after the participant’s death [Treas. Reg. 1.401(a)(9)-4, Q&A-4(a)].

In short, the designated beneficiaries are determined as of the date of death. Between date of death and the beneficiary designation date, a date of death beneficiary can be eliminated by disclaimer or distribution, but no new beneficiaries can be added.

**Liberalized Rules Regarding Beneficiary Designations**

Since a single table is prescribed in the 2002 Final Treas. Regulations (the Uniform Lifetime Table) to determine the spread period after the RBD, the identity of the beneficiary is not relevant prior to the IRA participant’s death (except if it is the IRA participant’s spouse and the spouse is more than 10 years younger than the IRA
participant). This represents an important liberalizing change from the 1987 proposed regulations. Under the 1987 Proposed Treas. Regs., in order for the spread period to be based upon joint life expectancy of the IRA participant and beneficiary, an effective beneficiary designation had to be in place as of the RBD, and the joint life spread period could not be increased even if the beneficiary were later changed to a person who was younger than the original beneficiary.

Under the 2002 Final Treas. Regs., since the identity of the beneficiary is not relevant prior to the IRA participant’s death, it does not matter if there has been no beneficiary designation as of the required beginning date (RBD) or if the beneficiary is changed. An exception to this general observation may apply, however, when the beneficiary is the IRA participant’s spouse. If the spouse is more than 10 years younger than the IRA participant, the spread period based upon their joint life expectancy will be greater than that applicable under the Uniform Lifetime Table that must be used for all situations when the beneficiary is other than a spouse. (The table assumes a beneficiary that is 10 years younger than the IRA participant.) Thus, the designation of such a spouse as beneficiary would decrease the required minimum distribution (RMD).

IRA participants past their required beginning date (RBD) may want to review their choice of beneficiary, since under the current rules they can change to a more favorable choice of “designated beneficiary” for post-death distributions. Under the old rules, changes were not possible after the required beginning date.

Beneficiary Determined after IRA Participant’s Death

After the IRA participant’s death the spread period will be based upon the life expectancy of the beneficiary (except in cases where the beneficiary is a surviving spouse who elects to treat the IRA as his or her own IRA, discussed below). For this purpose the identity of the beneficiary is fixed as of September 30 of the year following the year of death [Treas. Reg. §1.401(a)(9)-4, Q&A-4].

Postmortem Planning

The rule that allows the “designated beneficiary” to be determined as late as September 30 of the calendar year following the calendar year of the IRA participant’s death creates post-mortem planning opportunities for maximizing the post-death spread period; for example, when there are multiple potential beneficiaries (e.g., a primary and a secondary beneficiary, or two or more co-beneficiaries).

Trust as a Designated Beneficiary

As stated above, only an individual may be a designated beneficiary for purposes of determining the distribution period under IRC § 401(a)(9). Accordingly, a trust is not a designated beneficiary even though the trust may be named as a beneficiary. However, if the requirements set forth below are satisfied for any period during which required
minimum distributions (RMDs) are being determined by taking into account the beneficiary’s life expectancy, the individual beneficiaries of a trust (but not the trust itself) will be treated as having been designated as the participant’s beneficiaries under the plan for purposes of determining the appropriate distribution period [Reg. § 1.401(a)(9)-4, Q & A-5(a)].

For a trust to qualify as a “see-through” trust, it must comply with the following requirements [Treas. Reg. § 1.401(a)(9)-4, A-5(b)]:

- The trust must be valid under state law;
- The trust must be irrevocable or become irrevocable at the taxpayer’s death;
- The trust beneficiaries must be identifiable; and
- Certain documentation must be provided to the plan administrator or IRA custodian by October 31st of the year after the taxpayer’s death [Treas. Reg. section 1.401(a)(9)-4,A-5].

If these four tests are met, then the trust is a designated beneficiary (DB) and the required minimum distribution (RMD) will be based on the OLDEST trust beneficiary’s life expectancy [Treas. Reg. 1.401(a)(9)-5, A-7(a)(1)].

But there is, in essence, a fifth test for the trust to be a designated beneficiary, as all of the beneficiaries of the trust must be individuals the oldest of whom can be identified [Treas. Reg. 1.401(a)(9)-4, A-5(c); Treas. Reg. section 1.401(a)(9)-4, A-3]. Therefore, the fifth requirement is drafting the trust so that it is possible to determine the identity of the oldest beneficiary (“see-through trusts”), and ensuring only individuals are beneficiaries of the trust. By identifying the oldest beneficiary and being able to use the “lifetime expectancy method” on that person’s life would allow the beneficiaries of the trust to receive the most benefit from the IRA [Treas. Reg. 1.401(a)(9)05, Q&A-7]. This method is called the "lifetime expectancy method." The lifetime expectancy method is beneficial because it defers the income tax on the IRA distributions to be spread over the life of the beneficiaries of the trust while at the same time the assets in the trust are producing income and probably increasing in value, therefore allowing for more money to ultimately pass to the beneficiaries, than would have been the case if all of the assets were paid in a lump sum.

If the trust is eligible to use the lifetime expectancy method, distributions from the IRA will be made over the lifetime of the oldest beneficiary. However, if an IRA owner establishes separate accounts (subtrusts) for each beneficiary named directly during his or her lifetime, each beneficiary’s life expectancy will be used to calculate the required minimum distribution amounts needed to be paid out of the trust.

IRA benefits left to a trust that does not qualify for “see-through” status must be distributed using the no-designated beneficiary rules (5-year rule).
Conduit Trust

A Conduit Trust is similar to a trusteed IRA in its effects, so why would someone use one or the other? A separate trust with conduit provisions for the IRA asset is typically used if the trust donor has other assets to place in the trust besides the IRA, or if the IRA participant’s favorite financial institution does not offer trusteed IRAs, or if the IRA participant wants someone other than that particular financial institution to serve as trustee.

A conduit trust is a type of “see-through” trust where the trustee has no power to accumulate plan distributions in the trust. The trust simply receives the distributions from the IRA and then passes the income out to the beneficiaries, this is the most appropriate form of trust for the life expectancy method, because it is easier to determine all of the beneficiaries of the trust and which beneficiary’s life expectancy rate must be used to determine the distribution amounts from the IRA.

Under a Conduit Trust, the IRA and the trust are two different entities. The trust “owns” the inherited IRA as beneficiary after the participant’s death. The trustee withdraws the annual required minimum distributions (RMD) from the IRA and pays it out to the individual who is the beneficiary of the trust. The trustee can withdraw from the IRA more than the required minimum distribution (RMD), if the IRA participant/trust grantor so specifies in the trust instrument. However, whatever the trustee takes out of the IRA must be distributed to the trust beneficiary.

Note: A Conduit Trust for an IRA has minimum asset protection benefits (see Chapter 11 IRA Creditor Protection).

Accumulation Trust

If a trust is not a conduit trust, it is considered an “accumulation trust.” Unlike the trustee of a conduit trust, the trustee of an accumulation trust has the potential to accumulate, i.e. not pay out to the beneficiaries of the trust, some or all of the IRA benefits paid to the trust. Therefore, the remainder beneficiaries of the trust do count for purposes of the RMD rules.

If the IRA participant is seeking to put a barrier between the beneficiary and the money – for instance, if the beneficiary may be irresponsible with the money, has creditor protection issues, wants asset protection after the recent Clark vs. Rameker Supreme Court case that determined inherited IRAs are not otherwise protected assets, etc.—the whole point is to not just push all the money through from the IRA to the trust and immediately to the beneficiary (which puts it back in the beneficiary’s hands for spending or creditors). For creditor protection issues, certainly after the Supreme Court Ruling in the Rameker case, many IRA participants will pursue the purpose of an accumulation trust (see Chapter 11 IRA Creditor Protection)
Unfortunately, this dynamic means that not only will trust beneficiaries of IRAs often “need” to be accumulation trusts for planning purposes, but notably the use of an accumulation trust to gather the IRA distributions also generally means that the income tax consequences of the trust will occur at the trust level. This means being subject to compressed trust tax brackets that have a 39.6% top tax bracket starting with as little as $12,501 (see Table 7.3) in taxable income in 2017 (was $12,400 in 2016).

### Table 7.3
Estates and Trusts Tax Rates, 2017

<table>
<thead>
<tr>
<th>If Taxable Income Is Between:</th>
<th>The Tax Is</th>
<th>On Amount over:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $2250</td>
<td>15% of taxable income</td>
<td>$0</td>
</tr>
<tr>
<td>$2,251 - $6,000</td>
<td>$382.50 + 25%</td>
<td>$2,550</td>
</tr>
<tr>
<td>$6,001 - $9,150</td>
<td>$1,245.00 + 28%</td>
<td>$6,000</td>
</tr>
<tr>
<td>$9,151 - $12,500</td>
<td>$2,127.00 + 33%</td>
<td>$9,150</td>
</tr>
<tr>
<td>$12,501 +</td>
<td>$3,232.50 + 39.6%</td>
<td>$12,500</td>
</tr>
</tbody>
</table>

By contrast, if the trust passed through the IRA RMDs to the underlying trust beneficiary, the income tax consequences would generally flow through as well—the trust would claim a distributable net income (DNI) deduction to zero out its income, would report the income to the trust beneficiary recipient on a Form K-1, and the beneficiary would then claim the income on his/her own tax return (at his/her own, potentially lower, income tax bracket).

### No Named Beneficiary after IRA Participant’s Death

If no beneficiary has been finally determined by September 30 of the year following the year of death or if there is deemed to be no beneficiary under the applicable rules (e.g., where the beneficiary is not a natural person, such as a charity, or is a trust having a non-natural person as a beneficiary) the following rules apply:

- If the IRA participant died prior to his/her RBD the IRA must be fully distributed (through the IRA participant’s probate estate) by December 31 of the calendar year of the fifth anniversary of the IRA participant’s death (the so-called 5-year rule); or
- If death occurred after the RBD, the minimum payout schedule previously established, based on the life of the IRA participant alone, will continue after his or her death [Treas. Reg. §1.401(a)(9)-5, Q&A-5]. The post-death RMD payout period will be based upon the single life expectancy using the age of the IRA participant as of the birthday during the year of death, and reducing this by one for each calendar year thereafter [Treas. Reg. §1.401(a)(9)-5, Q&A-5(c)(3)].
5-Year Rule

The Rule: The Five-Year Rule applies when death of the IRA participant occurs before the required beginning date (RBD) or before the distributions begin. If an IRA participant dies before reaching the required beginning date or before the distribution of the participant’s interest begins, the general rule requires that the entire interest of the IRA participant must be distributed within five years of his or her death [IRC § 401(a)(9)(B)(ii)]. In order to satisfy the five-year rule, the IRA participant’s entire interest must be distributed by the end of the calendar year, which contains the fifth anniversary of the date of the IRA participant’s death [Treas. Reg. 1.401(a)(9)-(3), Q&A-2]. Prior to the end of such five-year period, there is no requirement that distributions be taken annually or in any other pro-rated manner. If desired, the entire distribution subject to the five-year rule can be withdrawn on December 31st of the fifth year.

Example: Tom died on January 15, 2011. If the five-year rule will be applicable, the entire interest in Tom’s account must be distributed by the end of 2017 in order to satisfy the rule.

5-Year Rule under WRERA

The Worker, Retiree, And Employer Recovery Act (WRERA of 2008) allowed beneficiaries taking the required minimum distributions under the 5-year rule to get an extra year to complete the payments. The 5-year period “shall be determined without regard to calendar year 2009 [IRC § 401(a)(9)(H)(ii)(II)].” Effectively, the “5-year rule” becomes the “6-year rule” for beneficiaries of decedents who die in the years 2004–2009. So, the new deadline for such beneficiaries is the end of the year that contains the sixth anniversary of the IRA participant’s death.

Example: Tom died on January 15, 2011 before his required beginning date (RBD), leaving his Traditional IRA to his estate. Because an estate is not a designated beneficiary, the 5-year rule applied, meaning that all amounts would have had to be distributed out of the IRA no later than 12/31/2016. However, because of WRERA, that deadline is extended to 12/31/2017.

Death of Beneficiary Prior To Beneficiary Finalization Date

An individual who is a beneficiary as of the date of the IRA participant’s death and dies prior to September 30 of the calendar year following the calendar year of death (without disclaiming) continues to be treated as a beneficiary as of such September 30 date, for purposes of determining the distribution period for required minimum distributions after the IRA participant’s death. Thus, that individual’s assumed life expectancy continues to be used in determining the payout period, rather than the life expectancy of any successor beneficiary [Treas. Reg. §1.401(a)(9)-4, Q&A-4(c)].
Applying Distribution Rules: Death Prior to the RBD

The first step in determining the required minimum distributions (RMDs) if the IRA participant dies before reaching his/her required beginning date (RBD) is to ascertain the identity of the designated beneficiary or beneficiaries. Is the primary beneficiary one of the following?

- The surviving spouse (sole designated beneficiary);
- A non-spouse designated beneficiary;
- A non-designated beneficiary;
- A trust; or
- One of multiple beneficiaries.

Let’s first discuss the rules when the surviving spouse is the primary beneficiary of the deceased spouse’s IRA and death occurred prior to the participant reaching his/her RBD.

Surviving Spouse as Beneficiary

A surviving spouse will have a choice of the following options:

- Lump Sum;
- 5-year Rule;
- Rollover; or
- Remain as Beneficiary (Inherited IRA-no rollover).

Lump Sum. Spouse takes a lump sum distribution of the IRA funds inside the deceased participant’s IRA and pays income taxes in the year of distribution.

Five-Year Rule. The surviving spouse can choose to take the deceased IRA participant’s entire interest by the end of the calendar year which contains the fifth anniversary of the date of the IRA participant’s death [Treas. Reg. 1.401(a)(9)-(3), Q&A-2] (see WRERA Rules for 2009).

Rollover. The current regulations continue and clarify the rule in the original 1987 Treas. Regs. which allows the surviving spouse of a deceased IRA participant to elect to treat an inherited IRA as the spouse’s own IRA. Thus, the surviving spouse may even make additional contributions into the IRA, and make rollover transfers from it [Treas. Reg. §1.408-8, Q&A-5]. A new payout period can be established, based upon the then age of the surviving spouse. No distributions will be required until the surviving spouse has reached 70½. If the surviving spouse had reached age 70½ prior to the IRA participant’s death, then the required beginning date (RBD) is December 31 of the calendar year following the year in which the decedent died [Ltr. Ruls. 9704019 and 9739034]. The minimum payout would be determined from the Uniform Lifetime Table, based upon the age of the surviving spouse. The surviving spouse may name a beneficiary to accede to the account upon the surviving spouse’s death. If the surviving spouse remarries and his
or her new spouse is designated as beneficiary, or if the new spouse is more than 10 years younger, minimum distributions can be based upon their actual joint life expectancy, which will result in a lower minimum required distribution than under the Uniform Lifetime Table.

The surviving spouse’s election to treat the deceased spouse’s IRA as his or her own may be made by affirmative action recharacterizing the IRA title. Additionally, the election is deemed to have been made if the required minimum distribution for any year is not in fact made to the surviving spouse, or if the surviving spouse makes a contribution into the account [Treas. Reg. §1.408-8, Q&A-5(b)].

These rules make the election consistent with the underlying premise that the surviving spouse could have received a distribution of the entire deceased participant’s IRA and rolled it over to an IRA in the surviving spouse’s own name. The affirmative election can be made at any time after the IRA participant’s death; thus, for example, the surviving spouse is not deemed to have waived his or her right to make this election as a result of having accepted the minimum distribution from the account for the year following the year of the IRA participant’s death. Required minimum distributions for years prior to the election will not trigger the 10 percent premature withdrawal penalty even if the surviving spouse had not attained age 59½ when they were received.

The regulations clarify that this election (whether by affirmative action or a deemed election) operates upon the following:

- Only after the distribution of what would have been the required minimum amount, if any, for the year of the IRA participant’s death (computed as if the owner had lived for the entire year) [Treas. Reg. §1.408-8,Q&A-4]; and
- Only if the spouse is the sole beneficiary of the account and has an unlimited right of withdrawal from the account. This requirement is not satisfied if the spouse’s interest is held through a trust, even if the spouse is the sole beneficiary of the trust [Treas. Reg. §1.408-8,Q&A-5(a)].

If the spouse actually receives a distribution from the IRA, the spouse is permitted to roll that distribution over within 60 days into an IRA in the spouse’s own name to the extent that the distribution is not a required minimum distribution, regardless of whether or not the spouse is the sole beneficiary of the IRA participant. Further, if the distribution is received by the spouse before the year that the IRA participant would have been 70½ no portion of the distribution is a required minimum distribution for purposes of determining whether it is eligible to be rolled over by the surviving spouse.

**Remain As A Beneficiary.** As under the 1987 Treas. Regs., if the IRA participant dies prior to age 70½, and the surviving spouse does not make the election to treat the inherited IRA as his or her own account, annual required minimum distributions need not commence until December 31 of the year in which the deceased IRA participant would have attained age 70½ [IRC § 401(a)(9)(B)(iv)(I)]. This rule, delaying the RBD until December 31 of the year that the deceased IRA participant would have reached 70½, in
cases where the surviving spouse is the beneficiary, is also applied where the beneficiary is a trust and the surviving spouse is the sole beneficiary [Treas. Reg. §1.401(a)(9)-5, Q&A-7(c)(3)].

Once the commencement date arrives, required minimum distributions are based upon the then life expectancy of the surviving spouse. If the surviving spouse dies before distributions to such spouse have begun under the foregoing rule, the relevant designated beneficiary for determining the distribution period is the designated beneficiary, if any, of the surviving spouse (determined as of September 30 of the calendar year following such spouse’s death), and distributions must commence by the end of the year following the year of the surviving spouse’s death. If there is no designated beneficiary with respect to the deceased surviving spouse, a 5-year rule applies; the entire account balance must be distributed no later than December 31 of the fifth calendar year after the year of the spouse’s death [Treas. Reg. §1.401(a)(9)-3,Q&A-5].

If the surviving spouse has not died before the first required minimum distribution, and the required minimum distributions are not commenced when otherwise required, the surviving spouse is automatically deemed to have elected to have the account treated as his or her own IRA account, with distributions to begin at his or her RBD [Treas. Reg. §1.408-8,Q&A-5].

**Non-Spouse Individual Designated Beneficiary**

If the IRA participant named a non-spouse designated beneficiary as the primary beneficiary and if there is one individual beneficiary named, such beneficiary must take required minimum distributions under one of the following three methods:

- Take a lump sum distribution;
- Take distribution by applying the requirements of the 5-year rule; or
- Take distribution over the life expectancy of the non-spouse designated beneficiary, as determined on the age of the beneficiary on his or her birthday falling in the year in which the IRA participant died. In such event, the distribution must begin no later than December 31st of the year after the year of the participant’s death [Treas. Reg. 1.401(a)(9)-3,Q&A- 3(a)].

The first year distribution (the year after the year of death) is determined based upon the corresponding life expectancy factor for the non-spouse designated beneficiary’s age in the year of the first distribution by reference to the Single Life Table years. This factor is reduced by one in each succeeding calendar year [Treas. Reg. § 1.401(a)(9)-3, Q&A-1(a) and Treas. Reg. § 1.401(a)(9)-3,Q&A-3(a)Treas. Reg. 1.401(a)(9)-5(c)(1)].

**Multiple Individual Beneficiaries (Designated Beneficiary)**

As long as the account is segregated prior to 12/31 of the calendar year following the calendar year of death, each beneficiary may independently calculate the required minimum distributions. Thus, with respect to each beneficiary, the first year distribution
(the year after the year of death) is determined based upon the corresponding life expectancy factor for the beneficiary’s age in the year of the first distribution by reference to the Single Life Table. For succeeding years, the factor is reduced by one [Treas. Reg. § 1.401(a)(9)-3,Q&A-1(a); Treas. Reg. § 1.401(a)(9)-3,Q&A-3(a)(2); Treas. Reg. § 1.401(a)(9)-5,Q&A-5(c)(1)and 7(a)].

**Trust as Beneficiary (Designated Beneficiary)**

The first year distribution (the year after the year of death) is determined based upon the corresponding life expectancy factor of the oldest beneficiary’s age in the year of the first distribution by reference to the Single Life Table. For succeeding years, this factor is reduced by one. If, the trust is designed to create “one pot” for the benefit of multiple beneficiaries, then required minimum distributions are based upon the oldest beneficiary’s life expectancy.

However, if the beneficiary designation is payable to separate sub-trusts, each separate sub-trust beneficiary may be able to use their respective life expectancies to calculate their required minimum distributions. However, multiple shares must be established prior to death. Many legal experts recommend a PLR should be requested if separate share treatment is desired [Treas. Reg. § 1.401(a)(9)-3,Q&A-1(a); Treas. Reg. § 1.401(a)(9)-3,Q&A-3(a); Treas. Reg. § 1.401(a)(9)-5,Q&A-7(a)].

**The Deadline:** It is important to note the deadline date of October 31st of the year following the year of death of the participant. This is a federal income tax deadline for delivering a copy of the participants will or trust agreement to an IRA custodian or qualified retirement plan administrator after the participant’s death.

**Non-Designated Beneficiary**

A non-designated beneficiary can be any one of the following:

- The Estate;
- A Non-qualifying Trust;
- Multiple Beneficiaries (not separated properly); or
- A Charity.

If there is a non-designated beneficiary named by September 30<sup>th</sup> of the year following the calendar year of the IRA participant’s death (and the participant died prior to his/her RBD), then the entire balance must be distributed no later than 12/31 of the fifth anniversary year of the decedent’s death (5-year rule) [Treas. Reg. § 1.401(a)(9)-3,Q&A 1(a)(1) & Q&A 2].
Applying Distribution Rules: Death On or After the RBD

Before calculating the required minimum distribution for a beneficiary, who inherited an IRA from a deceased participant who died on or after reaching his or her RBD, you must seek the answer to the following question: Did the deceased IRA participant take his or her required minimum distribution in the year of death?

Why is this question so important? The reason: If the deceased IRA participant, prior to death, did not take his or her required minimum distribution for the year of death, and if, the inherited IRA was transferred to the named beneficiary, then the beneficiary will be faced with a 50% penalty for not taking the required minimum distribution. **Reminder:** Most participants delay their required minimum distribution until close to the end of the year—12/31.

So, as you can see, it is very important to determine if the required minimum distribution was taken by the deceased prior to death. If not, it is the responsibility of the beneficiary to take the deceased’s required minimum distribution from the decedent’s IRA before the end of the year in which the IRA participant’s death occurred. In calculating the actual year of death required minimum distribution for the deceased IRA participant, the beneficiary would continue to use the method which was applicable to the deceased IRA participant [Treas. Reg. 1.401(a)(9)-5,Q&A-4(a)(1)].

Accordingly, if the deceased participant had already taken his or her required minimum distribution in the year of death, no additional distribution for such year is required.

Once the required distribution for the IRA participant’s year of death has been resolved, the next step is to identify the designated beneficiary or beneficiaries of the IRA participant as of the beneficiary finalization date-September 30th of the calendar year following the calendar year in which the IRA participant died. The identity of this (or these) beneficiary(ies) will be central in determining the subsequent required minimum distributions.

**Spouse as Designated Beneficiary**

The spouse will have the following options:

- Lump sum;
- Rollover; or
- Remain as beneficiary (Inherited IRA-no rollover).

**Lump Sum.** Spouse takes a lump sum distribution of the IRA funds inside deceased participant’s IRA and pays income taxes in the year of distribution.

**Spouse Rollover.** Required minimum distribution must be taken for year of decedent’s death based upon decedent’s age in year of death under the Uniform Lifetime Table.
Future year required minimum distributions are based upon surviving spouse’s life expectancy factor by reference to the Uniform Lifetime Table [Treas. Reg. § 1.408-8Q&A-5(a)].

**Remain as beneficiary (Inherited IRA No-rollover).** Required minimum distribution for the year of death must be taken based upon decedent’s life expectancy factor under the Uniform Lifetime Table (if not already taken by the decedent prior to death). Thereafter, the applicable distribution period is longer of:

- Surviving spouse’s life expectancy based upon the Single Life Table using the surviving spouse’s birthday for each distribution calendar year after the calendar year of the participant’s death up through the calendar year of the spouse’s death. For each succeeding year, this process is repeated (Recalculation Method); or
- Life expectancy of the deceased spouse under the Single Life Table using the age of the deceased spouse as of his or her birthday in the year of death, whereby in subsequent years, the factor is reduced by one [Treas. Reg. § 1.401(a)(9)-5,Q&A-5(c)].

Upon death of the surviving spouse, the required minimum distribution determined above must be withdrawn for the year of death (if not already taken by the decedent during his or her lifetime). For subsequent years, the required minimum distribution factor is fixed based upon the method chosen above. **Note:** If surviving spouse’s life expectancy is being used, his or her life expectancy is now fixed based upon the age of this spouse in the year of death by reference to the Single Life Table factor reduced by one [Treas. Reg. § 1.401(a)(9)-5,Q&A-5(c)].

**Non-Spouse Individual Designated Beneficiary**

Required minimum distribution must be taken for year of decedent’s death based upon decedent’s age in year of death (if not taken by the decedent during his or her lifetime). The first year distribution (the year after the year of death) is determined based upon corresponding life expectancy factor for the designated beneficiary’s (or the participant’s, if participant was younger than the designated beneficiary) age in the year of the first distribution by reference to the Single Life Table. For succeeding years, this factor is reduced by one [Treas. Reg. § 1.401(a)(9)-5,Q&A-5(c)(c)]; Treas. Reg. § 1.401(a)(9)-4,Q&A-4(a)]. See WRERA Rules.

**Multiple Individual Beneficiaries (Designated Beneficiary)**

Required minimum distribution must be taken for the year of decedent’s death based upon decedent’s age in year of death (if not already taken by the decedent during his or her lifetime). Thereafter, as long as the account is segregated (set up as separate accounts) prior to 12/31 of the year following death, each beneficiary may have independently required minimum distributions. Thus, with respect to each beneficiary, the first year distribution is determined based upon corresponding life expectancy factor for the beneficiary’s age in the year of the first distribution by reference to the Single Life Table.
For succeeding years, this factor is reduced by one [Treas. Reg. § 1.401(a)(9)-5,Q&A-5(c)(1); Treas. Reg. § 1.401(a)(9)-5,Q&A-7(a)].

**Trust as Beneficiary (Designated Beneficiary)**

Required minimum distributions must be taken for year of decedent’s death based upon decedent’s age in year of death (if not already taken by the decedent during his or her lifetime). The first year distribution is determined based upon corresponding life expectancy factor for the oldest beneficiary’s age in the year of the first distribution by reference to the Single Life Table. For succeeding years, this factor is reduced by one. If the trust is designed to create “one pot” for the benefit of multiple beneficiaries, RMDs are based upon the oldest beneficiary’s life expectancy. However, if the beneficiary designation is payable to separate sub-trusts, beneficiaries may be able to use their respective life expectancies to calculate required minimum distributions. **Note:** Many legal experts recommend a PLR should be requested if separate share treatment is desired [Treas. Reg. § 1.401(a)(9)-5,Q&A-5(c)(1); Treas. Reg. § 1.401(a)(9)-5,Q&A-7(a)].

**The Deadline:** It is important to note the deadline date of October 31st of the year following the year of death of the participant. This is a federal income tax deadline for delivering a copy of the participant’s will or trust agreement to an IRA custodian or qualified retirement plan administrator after the participant’s death.

**Non-Designated Beneficiary**

Required minimum distributions must be taken for the year of the deceased IRA participant based upon decedent’s age in year of death based on the Uniform Lifetime Table (if not already taken by the decedent during his or her lifetime). For succeeding years, determine initial factor by referencing the participant’s age in year of death in the Single Life Table. The factor is then reduced by one for each succeeding year [Treas. Reg. § 1.401(a)(9)-5,Q&A-5( c)(3)].

**IRA Distributions Due to a Divorce**

There is a difference in how IRAs – as opposed to qualified plans – are treated in divorce. Qualified plans are subject to Qualified Domestic Relations Orders (QDROs). In a QDRO, the ex-spouse becomes an alternate payee for all or part of the participant’s benefit under the terms of the plan.

IRAs are not subject to QDROs. Rather, IRA divisions in divorce are governed by IRC § 408(d)(6). That section states that if all or part of an IRA is transferred to a spouse or ex-spouse under a settlement or court order, as part of a divorce, the transfer is not treated as a taxable distribution. However, AFTER the transfer, the transferred portion of the IRA is no longer considered as the IRA of the transferor, but rather it is the IRA of the transferee ex-spouse [IRC § 408(d)(6), 530(d)(7)].
Another major difference between qualified plans and IRAs in divorce is that payments under a QDRO are exempt from the 10% early withdrawal penalty tax.

Once an IRA has been divided in a divorce, all the rules apply to that IRA as owned by the spouse, including the 10% penalty if distributions are taken prior to age 59½.

**Importance of Updating Beneficiary Designation Forms**

Failure to update one’s beneficiary designation for life insurance, annuities and retirement accounts is all too common. One of the most common problems stems from not changing beneficiary designations after a divorce. The law does not automatically cancel beneficiary designations in favor of a former spouse. This can cause a major disruption of the participant’s estate plan, have unintended consequences and create conflict among family members. As well as questioning the fiduciary responsibilities of the financial advisor.

Here is a case in fact: FINRA Panel Finds Ex-Wife Is IRA Beneficiary.

**Background:** In 1994, Newman Trowbridge Jr., an attorney, opened an IRA with Capital One Investment Services predecessor-in-interest through a previous broker. Thereafter, the account was assigned (“inherited”) to another financial advisor (Registered Representative). The named beneficiary of Mr. Trowbridge’s IRA account was his then-wife.

In 1999, the Trowbridges’ divorced after a protracted, bitter and acrimonious lawsuit. After the divorce, Mr. Trowbridge remarried and changed the beneficiary of several of his accounts (including his law firm’s profit sharing plan) to his estate. After his divorce and remarriage and after he changed beneficiaries on a number of his accounts in favor of his estate, Mr. Trowbridge then rolled the balance of the law firm’s profit sharing plan into his IRA. This rollover quadrupled the balance that had been in the IRA account.

Then, unexpectedly, Mr. Trowbridge died in 2009 and his widow (his 2nd wife) obtained an order requiring all account holders to pay owed funds to the estate. Capital One paid the IRA balance to Trowbridge’s ex-wife, however, because Mr. Trowbridge had failed to remove her as the named beneficiary.

**FINRA Arbitration Hearing:** In May of 2010, the estate of Newman Trowbridge filed with the Financial Industry Regulatory Authority (“FINRA”) Arbitration Statement of Claim, alleging that among other things, Respondents were guilty of negligence and a breach of fiduciary duty when they failed to advise Mr. Trowbridge to designate Lee Trowbridge (his 2nd wife and surviving spouse) as the IRA beneficiary in order for his wife to be recognized by Respondent Capital One as the owner or beneficiary of his IRA account.
During arbitration, in the Matter of the FINRA Arbitration Between Succession of Newman Trowbridge, Jr. through its Executrix, Lee Trowbridge, \textit{Claimant}, vs. Capital One Investment Services, LLC, and Rick E. Schenck, Sr. \textit{Respondents} (FINRA Arbitration 10-02435, May 9, 2011), the FINRA panel found that the order did not cover the IRA and dismissed the estate’s case, recommending that the matter be expunged from Schenck’s Central Registration Depository records.

\textbf{Lesson to be Learned}

In keeping with the “\textit{Know Your Customer Rule} (NYSE Rule), now replaced by FINRA Rule 2090, the Claimant argued that Respondents had a duty to periodically review Mr. Trowbridge’s accounts. Claimant suggested that such a review should have included a consideration of named beneficiaries in order to ensure that such were consistent with any changed circumstances in Mr. Trowbridge’s life. As such, if Respondents had discharged the duty that Claimant asserted existed, the inconsistent naming of the ex-wife as the IRA beneficiary would have become apparent to the Respondents and the ex-wife would not have benefitted from the dramatic increase in value when Mr. Trowbridge rolled the proceeds of his profit sharing plan into the IRA account.

Maybe the lesson here is to take the time to review all of your client’s IRA beneficiary designations yearly, no matter what the level of education or job title of the client, and if the client doesn’t want to meet with you to discuss this issue, document everything.
Chapter 7
Review Questions

1. True or False. A “primary beneficiary” is the IRA participant’s first choice for a beneficiary.
   ( ) A. True
   ( ) B. False

2. Which of the following would qualify as a designated beneficiary?
   ( ) A. An individual
   ( ) B. A charity
   ( ) C. A non-qualifying trust
   ( ) D. An estate

3. Which of the following is a type of “see-through” trust where the trustee has no power to accumulate plan distributions in the trust?
   ( ) A. Accumulation Trust
   ( ) B. Conduit Trust
   ( ) C. Miller Trust
   ( ) D. None of the above

4. When is the beneficiary finalization date?
   ( ) A. October 31st of the year following the year of the participant’s death.
   ( ) B. December 31st of the year of death of the participant.
   ( ) C. September 30th of the year following the year of the participant’s death.
   ( ) D. December 31st of the year following the year of the participant’s death.

5. If a trust is named primary beneficiary of an IRA, what is the date that the trustee must identify the beneficiaries to the IRA Trustee?
   ( ) A. October 31st of the year following the year of the participant’s death.
   ( ) B. December 31st of the year of death of the participant.
   ( ) C. September 30th of the year following the year of the participant’s death.
   ( ) D. December 31st of the year following the year of the participant’s death.
CHAPTER 8

ROTH IRA

Overview

The Roth IRA, the non-deductible alternative to Traditional IRAs, was enacted into the Internal Revenue Code in 1997. According to the Investment Company Institute, the Roth IRA has become the fastest growing IRA. Contributions to a Roth IRA are not tax deductible, and distributions are potentially tax and penalty-free if certain requirements are met. The Roth IRA is governed under IRC§ 408A.

This chapter will provide an in-depth review of the Roth IRA. It will define a Roth IRA, discuss how to set up and fund the Roth IRA, review the conversion rules mandated by the Tax Increase and Prevention Reconciliation Act (TIPRA) of 2005, and review the rules of the Designated Roth 401(k) Account (DRAC).

Learning Objectives

Upon completion of this chapter, you will be able to:

- Structure a Roth IRA;
- Explain the three methods to fund a Roth IRA;
- Apply the rules for Roth IRA contributions and conversions;
- Identify assets eligible for a Roth IRA conversion;
- Present the opportunity and prospects for a Roth IRA conversion;
- Explain the uses of Roth IRA recharacterizations and reconversions; and
- Observe the rules of the Designated Roth 401(k) plan.

Roth IRA Background

Prior to 1998, all IRAs had the same basic tax structure, as we discussed in Chapter 2. All of that changed with the passage of the Taxpayer Relief Act of 1997 (TRA-97), and specifically Section 302(a), which created IRC § 408A, and the Roth IRA. The Roth IRA, named after former Senate Finance Committee Chairman William Roth, Jr. (R-Del.), created an individual retirement arrangement providing tax advantages for “eligible” taxpayers, which became effective January 1, 1998.
Creating a Roth IRA

Many of the rules governing the Roth IRA are similar to those rules of the Traditional IRA under IRC§ 408, except for those rules explicitly defined in IRC § 408A (see Table 8.1).

Similar to a Traditional IRA, a Roth IRA can be either an account [IRC § 408(a)] or an annuity [IRC § 408(b)]. To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. A deemed-IRA can be a Roth IRA, but neither a SEP IRA nor a SIMPLE IRA can be designated as a Roth IRA.

Table 8.1
Traditional IRA vs. Roth IRA

<table>
<thead>
<tr>
<th>Traditional IRA [IRC § 408]</th>
<th>Roth IRA [IRC § 408A]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions made with pre-tax and after-tax dollars</td>
<td>Contributions made with after-tax dollars [IRC § 408A(c)(1)]</td>
</tr>
<tr>
<td>Principal grows tax-deferred</td>
<td>Principal grows tax-free</td>
</tr>
<tr>
<td>No contributions allowed after age 70½</td>
<td>Contributions allowed after age 70½ with earned income [IRC § 408A(c)(4)]</td>
</tr>
<tr>
<td>Required Minimum Distributions (RMDs) at age 70½</td>
<td>No Required Minimum Distributions for participant [IRC § 408A(c)(5)]</td>
</tr>
<tr>
<td>Distribution of pre-tax dollars 100% taxable; after-tax dollar recovery limited by pro-rata rules.</td>
<td>“Qualified” distributions are tax-free; “Non-qualified” distributions follow the “ordering rules” (first from contributions, next from converted amounts and last from earnings, which may have tax implications and penalty).</td>
</tr>
</tbody>
</table>

To be considered “qualified,” a distribution of earnings must meet the following two criteria: the distribution must be made after a five-year holding period, and the individual must have reached age 59½ (or have died or become permanently disabled). Earnings are tax-free only if withdrawn as qualified distributions.

Funding a Roth IRA

There are three ways to fund a Roth IRA. They are:

- First, regular annual contributions on behalf of an individual who has compensation;
- Second, conversion (rollover) of a Traditional IRA and/or a qualified plan to a Roth IRA; and
- Designated Roth IRA (DRAC) rollover from a qualified plan to a Roth IRA.

Each method to fund a Roth IRA has its own rules and eligibility requirements, let’s review those requirements beginning with annual contributions.
Regular Annual Contributions

In order for an individual to make a regular annual contribution to a Roth IRA, the individual must have compensation [Treas. Reg. § 1.408A-3]. The individual’s contribution to a Roth IRA will be limited to the amount of such individual’s compensation income for such year (or, if less, the dollar limit described below). Similar to all IRAs, contributions to a Roth IRA must be made in cash [IRC § 219(e)(1)].

The major difference between regular annual contributions to a Traditional IRA and a Roth IRA is that Roth IRA contributions are not deductible [IRC § 408A(c)(1)]. Accordingly, contributions to a Roth IRA are made with after tax non-deductible dollars instead of pre-tax deductible dollars.

Also, any individual regardless of his or her age, even if over age 70 ½, and regardless of whether he or she participates in a company retirement plan, may make a regular annual contribution to a Roth IRA. But of course, they must have compensation (similar rules for a Traditional IRA as discussed in Chapter 2).

Applicable Dollar Limit Defined

The amount that can be contributed depends on whether a contribution is made only to a Roth IRA or Traditional and Roth IRA.

- **Roth IRAs only.** If a contribution is made only to a Roth IRA, the maximum contribution limit is the lesser of:
  - $5,500 ($6,500 if participant is age 50 or older) in 2017 (same as in 2016);
  - Taxable compensation.

  However, if the participant’s modified adjusted gross income (MAGI) is above a certain amount, the contribution limit may be reduced (phased-out) as explained below.

- **Roth IRAs and Traditional IRAs.** If contributions are made to both Roth IRAs and Traditional IRAs established for the participant’s benefit, their contribution limit for Roth IRAs generally is the same as their limit would be if contributions were made only to Roth IRA but then reduced by all contributions (other than employer contributions under a SEP IRA and SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs [IRC § 408A(c)(2)(B)]. This means that a participant’s contribution limit in 2017 is the lesser of:
  - $5,500 ($6,500 if participant is age 50 or older) minus all contributions (other than employer contributions under a SEP IRA or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs;
  - Participant’s taxable compensation minus all contributions (other than employer contributions under a SEP IRA or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.
### Table 8.2
Roth IRA Applicable Dollar Limits (ADL)

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Basic Dollar Limit</th>
<th>Catch-up Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$5,500</td>
<td>$1,000</td>
</tr>
<tr>
<td>2017</td>
<td>$5,500</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590

However, if the participant’s MAGI is above a certain amount, their contribution limit may be reduced (phased-out) as explained below (see Table 8.3).

**Catch-Up Contribution.** The $1,000 catch-up contribution to the basic dollar amount is available to a participant who has attained age 50 by the end of the taxable year [IRC § 219(b)(5)(B)]. After the year 2008, IRC § 219(b)(5)(D) applies a cost of living adjustment (COLA) to the basic dollar limit (but not to the over 50 catch-up contribution amount) in increments of $500 per year. As a result of the PPA of 2006, the above contribution limits will not “sunset” after 2010. The catch-up contribution is $1,000 for 2017 (same as in 2016).

### MAGI Defined

Modified adjusted gross income (MAGI) is a measure of income used to determine how much of a non-deductible contribution can be made to a Roth IRA. The IRS says that MAGI for Roth IRA purpose is adjusted gross income (AGI) as shown on line 37 of the 1040 modified as follows:

- Subtract the following:
  - Conversion income. This is any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA; and
  - Minimum required distributions from qualified retirement plans, including IRAs, (for conversions only).
- Add the following:
  - Traditional IRA deduction;
  - Student loan interest deduction;
  - Tuition and fees deduction;
  - Foreign earned income exclusion;
  - Foreign housing exclusion or deduction;
  - Exclusion of qualified bond interest shown on Form 8815;
  - Exclusion of employer-provided adoption benefits shown on Form 8839; and
  - Domestic production activities deduction from Form 1040, line 35, or Form 1040NR, line 33.
For purposes of the income limits applicable to both regular Roth IRA contributions and Roth IRA conversions, MAGI does not include the deemed distribution amount that results from converting a Traditional IRA to a Roth IRA [IRC §408A(c)(3)(C)(i)]. So if, in the year being tested, the participant converts a Traditional IRA to a Roth IRA, resulting in the inclusion of some or all of the conversion amount in his/her gross income, the gross income resulting from the conversion is disregarded solely for purposes of determining whether the taxpayer’s MAGI is low enough to make him or her eligible to contribute.

**Roth IRA Annual Contribution Phase-out Rules**

Table 8.3 shows the MAGI phase-out rules for making a regular annual contribution to a Roth IRA [IRC § 408A(c)(3)(C)]:

<table>
<thead>
<tr>
<th>If you have taxable compensation and your filing status is…</th>
<th>And your MAGI is…</th>
<th>Then…</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2016</td>
<td>2017</td>
</tr>
<tr>
<td>Married Filing Jointly or Qualifying Widow(er)</td>
<td>$184,000 or less</td>
<td>$186,000 or less</td>
</tr>
<tr>
<td></td>
<td>At least $184,000 but less than $194,000</td>
<td>At least $186,000 but less than $196,000</td>
</tr>
<tr>
<td></td>
<td>$194,000 or more</td>
<td>$196,000 or more</td>
</tr>
<tr>
<td>Single or Head of Household or Married Filing Separately and did not live with spouse at any time during the year</td>
<td>$117,000 or less</td>
<td>$118,000 or less</td>
</tr>
<tr>
<td></td>
<td>At least $117,000 but less than $132,000</td>
<td>At least $118,000 but less than $133,000</td>
</tr>
<tr>
<td></td>
<td>$132,000 or more</td>
<td>$133,000 or more</td>
</tr>
<tr>
<td>Married Filing Separately and lived with your spouse at any time during the year</td>
<td>Less than $10,000</td>
<td>Less than $10,000</td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>You cannot contribute to the Roth IRA.</td>
</tr>
</tbody>
</table>

Source: IRS Publication 590
The general maximum contribution formula is as follows:

\[
\begin{align*}
\text{Maximum Compensation} & \quad -- \quad \text{MAGI} \\
\text{Maximum Possible Contribution} & \quad - \quad \text{Minimum Compensation} \\
\text{Threshold} & \quad - \quad \text{Threshold} \\
\end{align*}
\]

\[= \text{Maximum Allowable Contribution}\]

**Example**: Tom, age 45, files as a single taxpayer with MAGI of $121,000 in 2017. The maximum contribution he can make to a Roth IRA for 2017 is $4,400 computed as follows:

\[
\begin{align*}
\text{Maximum Compensation} & \quad = \quad $5,500 \\
\text{MAGI} & \quad = \quad $133,000 \\
\text{Minimum Compensation} & \quad = \quad $121,000 \\
\text{Threshold} & \quad = \quad $133,000 \\
\text{Threshold} & \quad - \quad $118,000 \\
\end{align*}
\]

\[= \text{Maximum Allowable Contribution}\]

\[
\begin{align*}
\text{Maximum Compensation} & \quad = \quad $5,500 \\
\text{Minimum Compensation} & \quad = \quad $12,000 \\
\text{Threshold} & \quad = \quad $15,000 \\
\end{align*}
\]

\[= \$4,400\]

Above the phase-out levels, taxpayers can still contribute to a traditional, non-deductible IRA, even if their AGI exceeds the phase-out amounts for deductible or Roth IRAs.

There is no maximum age limit for contributing to a Roth IRA, as there is for contributions to a Traditional IRA; an individual (who earns compensation) can contribute to a Roth IRA even after age 70½ [IRC § 408(c)(4)].

Also, a person who meets the income test and has compensation income may contribute to a Roth IRA regardless of whether he or she is an “active participant” in an employer plan during the same year.

**Spousal Roth IRA Contributions**

An individual is allowed to make Roth IRA contributions on behalf of his or her spouse, only if they meet the income eligibility requirements (as discussed above). The same contribution amounts are allowed for a Spousal Roth IRA.
Excess Contributions to Roth IRAs

Excess contributions to a Roth IRA will be subject to the same 6% excise tax as was discussed in Chapter 2. Excess contributions are considered to be contributions made by a participant to his or her Roth IRA for a year that equals the total of:

- Amounts contributed for the tax year to the Roth IRA (other than amounts properly and timely rolled over to a Roth IRA or properly converted from a Traditional IRA) that are more than the participant’s contribution limit for the year; plus
- Any excess contributions for the preceding year, reduced by the total of:
  - Any distributions out of the participant’s Roth IRAs for the year, plus
  - Participant’s contribution limit for the year minus their contributions to all their IRAs for the year.

Withdrawals of Excess Contributions

For purposes of determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing the participant’s tax return for the year is treated as an amount not contributed. This treatment only applies if any earnings on the contributions are also withdrawn. The earnings are considered earned and received in the year the excess contribution was made.

Example: Tom makes a $5,500 contribution to a Roth IRA early in 2017, then later realized that his income would only allow him to make a contribution of only $4,300. His excess contribution was $1,200. If he does not correct the excess contribution for 2017, he’ll have to pay $72 excess contribution tax (6% of $1,200). And, if he left the problem uncorrected beyond the end of 2018, he will owe another $72. Tom will continue to owe this tax each year until he corrects the excess contribution.

Corrective Action

There are four ways to correct an excess contribution to a Roth IRA. Two of them can be used to completely avoid the excess contribution penalty, and the other two prevent it from applying to later years after it has applied to one or more years. Depending on the specific situation, you may find that one or more of these correction methods are unavailable.

- First, withdrawing excess by due date of return. If a contribution to a Roth IRA was improper or too large, the participant (owner) can avoid the 6% penalty tax by taking the money out. Relief from the penalty is available only if the following are true:
The participant receives a distribution from the Roth IRA on or before the
due date (including extensions) for filing the tax return for the year of the
contribution; and
The distribution includes the amount of the excess contribution and the
amount of net income attributable to the excess.

Choosing this method of correction, the participant must report and pay tax on the
net income attributable to the excess in the year of the contribution, even if the
participant takes it out during the following year, before the return due date. The
earnings will be taxed like any other taxable distribution of earnings from a Roth
IRA, and will be subject to the early distribution penalty if under age 59½ unless
one of the exceptions applies;

- Second, do a recharacterization. Another way to correct an excess contribution is
to have the trustee of the Roth IRA make a direct transfer from the Roth IRA to a
Traditional IRA. To avoid penalties, there are requirements that must be met (as
was discussed above):
  - The transfer must occur on or before the due date (including extensions)
    for filing the return for the year of the contribution; and
  - The transfer must include the amount of the excess contribution and the
    amount of net income attributable to the contribution.
If the participant can meet these requirements, he/she will be treated as if the
contribution went to the Traditional IRA in the first place. That means the
participant will not have to pay tax on the earnings that are transferred from one
IRA to another. The IRS calls this a recharacterization.

Example: Suppose you contribute $5,500 to a Roth IRA early in 2016,
epecting your MAGI to be below the income limitation for Roth IRA
contributions. At the end of the year you find that your MAGI is higher than
expected and your Roth IRA contribution limit is $3,500. Before October 15,
2017 you have the trustee of your Roth IRA transfer $2,000 plus the earnings
attributable to that $2,000 directly to a Traditional IRA. You’re treated as if
you originally contributed $3,500 to the Roth IRA and $2,000 to the
Traditional IRA.

Note: Many people mistakenly believe a recharacterization can be used only as a
way to undo a Roth conversion, but it can also be used to change the type of IRA
to which a contribution was made;

- Third, make a later withdrawal. If the participant fails to take a corrective
distribution within the time period described above, he/she will incur the excess
contribution penalty for the year of the contribution and incur it again for each
subsequent year it remains uncorrected. The participant can prevent it from
applying to a subsequent year by withdrawing the excess from his/her Roth IRA,
but the rules here are different than for the type of correction described earlier.
The participant needs to act by the end of the year, not by the due date of the
return for that year. If the participant’s excess contribution was made in 2016,
he/she must act by December 31, 2017 to avoid a penalty for 2017. Note: This is
only 2½ months after the deadline for correcting the original year, as described earlier. When using this correction method the participant doesn’t have to withdraw earnings. The participant simply withdraws the amount of the excess contribution; and

- *Fourth, contribute less than maximum.* The last way to correct an excess contribution is to contribute less than the maximum in a subsequent year.

**Example:** If the participant has a $2,000 excess contribution in 2016 and he/she contributes at least $2,000 less than the maximum allowed to contribute in 2017, the participant will incur the excess contribution penalty for 2016 but not for 2017 or later years. The nice thing about this particular method of correction is that it sometimes happens purely by accident. People sometimes discover an excess contribution from a few years earlier and find that it was automatically corrected in a subsequent year when they contributed less than the maximum.

### Roth IRA Conversions

The second way to get funds into a Roth IRA is to rollover/convert funds to it [IRC § 408A(d)(3)]. But before we get into the specifics of the Roth Conversion let’s clear something up: the difference between a rollover and a conversion. Prior to the arrival of Roth IRAs, “*rollovers*” were always tax-free, and most people still associate that word with tax-free transfers from one retirement plan to another. In contrast, the rollover of funds from an individual retirement plan (like a Traditional IRA) to a Roth IRA is taxable. Therefore, the term “*conversion*” is often used for the rollover of funds from a Traditional IRA to a Roth IRA, which is a taxable event, as a way to distinguish that type of rollover from a “normal” rollover, which is nontaxable.

When doing the conversion, the amount converted is included in the participant’s gross income and is subject to tax as if it were distributed from the Traditional IRA or qualified retirement plan and not re-contributed to another IRA [IRC § 408A(d)(3)(A)(ii)]. But, the conversion will not be subject to the 10% penalty for premature distribution from a QRP under IRC § 72(t)(1) [IRC § 408A (d) (3) (A) (ii)]. And, since there is no limit on the amount that can be converted, a conversion contribution can be a greater amount than the normal maximum regular annual contribution amount to a Roth IRA.

### Eligibility Requirements for Conversion

Prior to 2010, a participant could only convert from a Traditional IRA into a Roth IRA, if they met the following requirements:

- *Income Limit.* Participant’s Adjusted Gross Income (AGI) is not more than $100,000 [IRC § 408A(c)(3)(B)(i)]. For a married couple filing jointly, the
$100,000 limit applies to the MAGI of the couple, not of each spouse [Reg. § 1.408A-4, A-2(b)];

- **Filing Status.** Generally no conversion is permitted if the taxpayer is married filing a separate return for the year [IRC § 408A(c)(3)(B)(ii)] . However, if a married individual has lived apart from his or her spouse for the entire taxable year, then such individual can treat himself or herself as not married for purposes of the income test, file a separate return and be subject to the $100,000 limit on his or her separate MAGI; and

- **Age.** A participant who meets the income and filing status tests can convert his/her Traditional IRA to a Roth IRA regardless of his or her age even after the individual for whom the account is maintained has attained age 70 ½ [IRC § 408A(c)(4)].

**New rules effective January 1, 2010.** Under Section 512 of the *Tax Increase Prevention and Reconciliation Act* (TIPRA) of 2005, the $100,000 income conversion limit was repealed effective January 1, 2010. Roth IRA conversions are now permitted if adjusted gross income exceeds $100,000. All taxpayers are now allowed to convert, including those who file married filing separately (MFS).

Also, if a Roth IRA conversion was made during 2010, the income from the conversion was recognized ratably over 2011 and 2012, unless the taxpayer elected to recognize all of it in 2010.

**Conversion Methods**

According to Reg. Sec. 1.408A-4 Q&A-1(b), there are three methods that a participant can use to effect the conversion from a Traditional IRA to a Roth IRA. They are:

- **Rollover (In-direct).** A distribution from a Traditional IRA may be contributed (rolled over) to a Roth IRA within 60 days after the distribution is made [IRC §408(d)(3)(A)(i)].

- **Trustee-to-Trustee Transfer (Direct).** You can direct the trustee of the Traditional IRA to transfer an amount from the Traditional IRA to the trustee of the Roth IRA.

- **Recharacterized.** All or part of a Traditional IRA can simply be “recharacterized” (re-designated) as a Roth IRA maintained by the same trustee or custodian [Treas. Reg. § 1.408A-4, A-1(b)(3)] (discussed below).

A participant can withdraw all or part of the asset from a Traditional IRA and reinvest (within 60 days) in a Roth IRA. If properly (and timely) rolled over, the 10% additional tax penalty for premature distributions will not apply.

The one-rollover-per-year limitation in IRC § 408(d)(3)(B) does not apply to a conversion to a Roth IRA, so such conversions may occur even if it is within 12 months of a tax-free Traditional IRA-to-IRA rollover. [Treas. Reg. § 1.408A-4, A-1(a)].
You must roll over into the Roth IRA the same property the participant received from the Traditional IRA. The participant is allowed to rollover either all or part of the withdrawal into a Roth IRA, or keep the part not rolled over. The amount the participant keeps will generally be taxable (except for the amount that is a return of non-deductible contributions) and generally may be subject to the 10% tax on early distributions.

Other types of allowable conversions are:

- **Periodic Distributions.** An individual who has started taking a series of substantial equal periodic payments (SOSEPP) from a Traditional IRA can convert the account to a Roth IRA and then continue the periodic payments. The 10% early distribution tax will not apply even if the distributions are not qualified distributions as long as it is part of a series of substantial equal periodic payments; and
- **Simple IRA to a Roth IRA.** Generally, a participant in a SIMPLE IRA can convert to a Roth IRA, under the same rules discussed above. However, the participant cannot convert any amount distributed from the SIMPLE IRA during the 2-year period beginning on the date the participant first participated in any SIMPLE IRA plan maintained by his/her employer (25% penalty).

Conversions not allowed:

- **Required Minimum Distributions.** Amounts that must be distributed to a participant from a Traditional IRA for a particular year (including the calendar year in which the participant reaches age 70½) under the RMD rules cannot be converted; and
- **Inherited IRA.** If an individual inherited a Traditional IRA from someone other than a spouse, you cannot convert it to a Roth IRA.

**“Backdoor” Roth IRA Conversion Strategy**

As discussed above, for many of your high-income clients, the IRS phase-out rules preclude them from making direct Roth IRA contributions. For single tax filers the income phase-out threshold is $133,000 for 2017 (up from $132,000 in 2016); for married couples filing jointly $196,000 in 2017 (up from $194,000 in 2016).

The “Backdoor” Roth IRA conversion strategy suggests a workaround for those clients who earn too much money, allowing them to make non-deductible $5,500 (or $6,500 non-deductible catch-up contributions for those over age 50) annually to their non-deductible IRA, and then convert the IRA to a Roth. Since neither transaction has an income limit, and the non-deductible IRA includes after-tax contributions, the end result is that the client annually completes the equivalent of a Roth contribution, neatly dodging the existing Roth IRA contribution income limits, while having no immediate tax impact (since the non-deductible IRA contributions has no tax consequences, nor does the Roth IRA conversion whose non-deductible contributions equal its current value).
However, there are a couple of rules to take into consideration. They are:

- The IRA “aggregation rule” under (IRC § 408(d)(s); and
- The “step transaction doctrine.”

IRA Aggregation Rule

Under IRC § 408(d)(2), the “IRA aggregation rule,” stipulates that when a Roth IRA conversion occurs, the taxpayer must calculate the income tax consequences of a Roth IRA conversion by aggregating together all of the taxpayer’s IRAs. As a result, other pre-tax IRA funds can distort the tax consequences of the contribute-then-convert strategy.

Example: Assume your client contributes $5,500 to a non-deductible IRA with the intention of converting it. However, your client also has a $150,000 pre-tax IRA, the accumulation of several prior 401(k) rollovers, and $12,000 of non-deductible contributions from many years ago. When your client converts his newly created $5,500 non-deductible IRA, he cannot simply convert at a tax cost of $0. Instead, the IRA aggregation rule applies. His total non-deductible contributions are $12,000 + $5,500 = $17,500, and his total IRAs are $150,000 + $5,500 = $155,500. Accordingly, when your client converts the $5,500 non-deductible IRA contribution, the portion that is non-taxable will be $17,500 / $155,500 = 11.25%, or $619. The remaining $4,881 will be taxable income, due to the application of the IRA aggregation rule; this result occurs even if all the new non-deductible contributions are made to a separate account which is converted.

The Step Transaction Doctrine

There is some controversy over the “backdoor” Roth conversion strategy in that it may involve the risk that the IRS will apply the “step transaction doctrine,” invalidating the strategy entirely.

The “step transaction doctrine” is the legal principle that a series of related steps in a transaction should be taxed based on the overall economic nature of the transaction, not “just” based on the separate individual steps. In the context of the “backdoor” Roth IRA conversion strategy, the step transaction doctrine would examine the overall result of the transaction—dollars came out of a taxable account and ended up in a Roth IRA—and tax it according to the substantive result that occurred; that the taxpayer constructively made a contribution to a Roth IRA. After all, the taxpayer contributed to the non-deductible IRA for the sole-purpose of converting it to a Roth IRA, and did those two steps together for the sole purpose of getting a new annual contribution into a Roth IRA. In the end, the net result is that the taxpayer constructively made a Roth IRA contribution. According to the step transaction doctrine, if that’s really what happened, then the IRS can tax it accordingly.
Of course, Roth IRA contributions themselves are not actually taxable anyway. They are a contribution of after-tax funds in the first place. But treating the transaction as being substantively the same as a Roth IRA contribution does mean that the client now made a Roth IRA contribution while his/her income is too high (assuming that's the case; otherwise the client would simply make a direct Roth IRA contribution in the first place). And if income exceeded the limits when the Roth contribution was made, the client has made an excess contribution that must either be unwound or be subject to the 6% excess contribution penalty tax.

So does the strategy of contributing to a non-deductible IRA and converting it to a Roth IRA to avoid the Roth IRA contribution income limit constitute a step transaction scenario? The reality is that the application of the step transaction doctrine is done on a case-by-case basis, and depends on a subjective interpretation of the facts and circumstances of the client's particular situation. What do the courts look for in evaluating the potential of a step transaction? Simply put, they are looking for a series of transactions, all inter-related, where the final outcome of the overall series of transactions was to accomplish the equivalent of another single-step (or fewer steps) transaction. In the case of a client who contributes to a non-deductible IRA, specifically for the purpose of converting it, and does those multiple steps precisely because it is a way to try to avoid the Roth IRA contribution income limits, then it seems clear that the step transaction doctrine could be applied. In point of fact, it is exactly these kinds of scenarios – multiple related transactions done to obfuscate the tax consequences of the same event in a single transaction – that the step transaction doctrine was designed to address (in the interests of reducing "abusive" tax avoidance strategies)!

However, there are a number of financial professionals that have suggested that the step transaction does not apply to the backdoor Roth IRA conversion strategy and that the transaction should happen immediately. While other financial professionals recommend allowing a certain period of time (12 months) to lapse between the two steps.

**Note:** As the advisor it is very important for you to understand that every taxpayer has a unique set of facts and circumstances and they should seek advice from their own tax and legal representatives. And, also, the various companies that offer IRAs may have their own rules on conversions.

**Eligible Assets to Be Converted**

Following are the eligible assets that can be converted (rolled over) to a Roth IRA:

- Traditional IRAs [IRC § 408A(c)(3)(8)]. Except Inherited IRAs and Educational IRAs;
- SEP IRAs;
- SIMPLE IRAs (after 2nd year due to 25% penalty [Treas. Reg. § 1.408A-4]); and
- Qualified retirement plans (IRC § 401(a), IRC § 403 (a)(b), and IRC § 457).
Prior to 2008, only IRAs, and no other kinds of retirement plans, could be “converted” into Roth IRAs. So to convert money in a qualified plan to Roth status there was a two-step process:

- Step 1: Participant had to convert the qualified retirement plan to a Traditional IRA; and
- Step 2: Once QRP is converted to a Traditional IRA, the Traditional IRA would then be converted to the Roth IRA.

**Drawback for the two-step process:** When doing the conversion from the Traditional IRA to the Roth IRA the participant had to take into considerations the following rules:

- Aggregation Rule: Must aggregate all Traditional IRAs as one; and
- The Pro-rata rule must be used when making a conversion that has basis in the Traditional IRA.

All that changed with the passage of the PPA of 2006, Section 824, which amended the definition of qualified rollover contribution under IRC § 408A(e) to allow a Roth IRA to accept rollovers from other eligible retirement plans directly, effective for distributions made after December 31, 2007.

Those “eligible retirement plans” [as defined in IRC § 402(c)(8)(B)] include:

- Defined benefit plans;
- Defined contribution plans (including an IRC § 401(k) plan);
- Annuity plans [IRC § 403(a)];
- Tax-sheltered annuity plans [IRC § 403(b) plan]; and
- Governmental deferred compensation plans [IRC § 457 plans].

This new tax law change creates the opportunity to complete the Roth conversion transfer directly by allowing the entire process to be accomplished much more efficiently. It eliminates an extra transfer (two-step process), and extra financial account and institution that could potentially make a mistake, and expedites the timeliness of the process, which may be particularly useful for those wishing to complete an end-of-year Roth conversion transaction by December 31st.

Although the expedited administrative ease of the direct Roth conversion is a substantial benefit, the new rules provide another significant planning opportunity as well. Direct Roth conversions create the ability to avoid the IRC § 408(d)(2) aggregation rules that require all IRAs to be considered a single IRA when determining the tax consequences of a distribution (including a Roth conversion). These rules are particularly troublesome where the retirement accounts hold substantial after-tax contributions that could otherwise be recovered tax-free in the Roth conversion process.

An example can help to best illustrate the additional planning flexibility provided by the opportunity to avoid the aggregation rules:
**Example:** John Smith Accounts:

**Old Rules:** 401(k) plan is rolled over to a new IRA account. The new $150,000 IRA account with the $30,000 of after-tax contributions is converted to a Roth IRA. However, because of IRC § 408(d)(2) aggregation rules, the $150,000 Roth conversion is treated as being a partial conversion of the aggregate $650,000 of IRA accounts with an aggregate $30,000 of after-tax contributions. Since the after-tax contributions are recovered on a pro-rata basis, the distribution is considered to be only 4.615% tax-free ($30,000 / $650,000).

Thus, the $150,000 conversion will be taxed as a $6,923 return of principal (4.615% x $150,000) and $143,077 of ordinary income.

**NEW RULES:** 401(k) plan is rolled directly to a Roth IRA account. Since the funds are never held in an IRA, they are not subject to the IRC § 408(d)(2) aggregation rules.

Consequently, the $150,000 Roth conversion is treated as a $30,000 return of principal (since there were $30,000 of after-tax contributions in the 401(k) account), and a $120,000 ordinary income conversion.

Despite the need for caution to ensure that the Roth conversion is otherwise still appropriate, the new provisions of Section 824 of PPA 2006 are beneficial to those interested in completing Roth conversions from employer retirement plans.

Beyond mere administrative ease, the new rules actually create a particularly appealing opportunity for Roth conversion with employer retirement plans that hold substantial after-tax contributions, due to the ability to avoid the IRA aggregation rules.

**IRS Notice 2008-30.** On March 5th, 2008, the IRS issued further guidance regarding certain distribution-related provisions of the Pension Protection Act of 2006 (PPA). Surprisingly, this Notice appears to allow beneficiaries of inherited IRAs to convert to a Roth IRA. As discussed above, prior to amendment by the PPA, a Roth IRA could only accept a rollover contribution of amounts distributed from a “qualified rollover” and non-spouse beneficiaries who inherited an IRA could not rollover to a Roth IRA. However, Q&A #7 of Section II in Notice 2008-30, appears to expand this conversion power to non-spousal beneficiaries. Q&A #7 specifically states as follows:

- Q-7. Can beneficiaries make qualified rollover contributions to Roth IRAs?
  - A-7. Yes. In the case of a distribution from an eligible retirement plan [which includes an IRA and 403(a) annuity, a 403(b) annuity, a qualified trust under 401(a), and a deferred compensation plan under 457 (b)] other than a Roth IRA, the MAGI and filing status of the beneficiary are used to determine eligibility to make a qualified rollover contribution to a Roth IRA. Pursuant to IRC § 402(c)(1), a plan may but is not required to permit rollovers by non-spouse beneficiaries and a non-spouse beneficiary that is ineligible to make a IRA may recharacterize the contribution pursuant to IRC § 408A(d)(6).
This provides amazing planning opportunities for beneficiaries. While the non-spousal beneficiary will still have to begin taking required minimum distributions (RMDs) from the Roth IRA during his/her lifetime, for many clients a substantial benefit continues to exist.

**Prospects for Roth IRA Conversion**

The consensus view is that the conversion route should be considered by taxpayers who:

- Have a number of years to go before retirement (and are therefore able to recoup the dollars that are lost to taxes on account of the conversion);
- Anticipate being taxed in a higher bracket in the future than they are now; and
- Can pay the tax on the conversion from non-retirement-account assets (otherwise, there will be a smaller buildup of tax-free earnings in the depleted retirement account).

When considering whether a conversion to a Roth IRA is appropriate, it is important to consider the IRA owner’s current and future expected tax bracket during retirement. Table 8.4 displays the 2016 federal income tax brackets and Table 8.5 displays the 2017 federal income tax tables.

**Conversion Advantages**

The principal advantage to converting to a Roth IRA is that, by paying the income tax on the conversion out of other assets, you are effectively making a substantial additional contribution to your IRA.

*Example:* Mary has a $1 million Traditional IRA, and $300,000 of other money. Mary is in a 30% income tax rate. If, Mary converts to a Roth IRA and uses her $300,000 of other money to pay the income tax, she will have a $1 million Roth IRA. Over some period of time, it grows to $2 million.

Over the same period of time, if Mary did not convert to a Roth IRA, her $1 million Traditional IRA will grow to the same $2 million or $1.4 million after income tax. But since Mary’s taxable account is subject to income tax each year, it will grow to something less than $600,000. Therefore, Mary would end up with less than $2 million in total.
Table 8.4
2016 Federal Income Tax Brackets

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<th>FIT TB</th>
<th>MFJ</th>
<th>Single Filers</th>
<th>Head of Household</th>
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</thead>
<tbody>
<tr>
<td>10.0%</td>
<td>$0 – $18,550</td>
<td>$0 – $9,275</td>
<td>$0 – $13,250</td>
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<tr>
<td>15.0%</td>
<td>$18,551 – $75,300</td>
<td>$9,276– $37,650</td>
<td>$13,251- $50,400</td>
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<td>25.0%</td>
<td>$75,301 – $151,900</td>
<td>$37,651– $91,150</td>
<td>$50,401- $130,150</td>
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<td>28.0%</td>
<td>$151,901– $231,450</td>
<td>$91,151 – $190,150</td>
<td>$130,151- $210,800</td>
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<tr>
<td>33.0%</td>
<td>$231,451– $413,350</td>
<td>$190,151 – $413,350</td>
<td>$210,801 - $413,350</td>
</tr>
<tr>
<td>35.0%</td>
<td>$413,351– $466,950</td>
<td>$413,351 – $415,050</td>
<td>$413,351– $441,000</td>
</tr>
<tr>
<td>39.6%</td>
<td>Over $466,950</td>
<td>Over $415,050</td>
<td>Over – $441,000</td>
</tr>
</tbody>
</table>

Table 8.5
2017 Federal Income Tax Brackets

<table>
<thead>
<tr>
<th>FIT TB</th>
<th>MFJ</th>
<th>Single Filers</th>
<th>Head of Household</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.0%</td>
<td>$0 – $18,650</td>
<td>$0 – $9,325</td>
<td>$0 – $13,350</td>
</tr>
<tr>
<td>15.0%</td>
<td>$18,651 – $75,900</td>
<td>$9,326– $37,950</td>
<td>$13,351- $50,800</td>
</tr>
<tr>
<td>25.0%</td>
<td>$75,901 – $153,100</td>
<td>$37,951– $91,900</td>
<td>$50,801- $131,200</td>
</tr>
<tr>
<td>28.0%</td>
<td>$153,101– $233,350</td>
<td>$91,901 – $191,650</td>
<td>$131,201- $212,500</td>
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<td>33.0%</td>
<td>$231,351– $416,700</td>
<td>$191,651 – $416,700</td>
<td>$212,501 - $416,700</td>
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<td>35.0%</td>
<td>$416,701– $470,700</td>
<td>$416,701 – $418,400</td>
<td>$416,701– $444,550</td>
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<tr>
<td>39.6%</td>
<td>Over $470,700</td>
<td>Over $418,400</td>
<td>Over – $444,550</td>
</tr>
</tbody>
</table>

Conversion of an Annuity Contract

If a Traditional IRA is being converted to a Roth IRA, and one of the IRA assets being converted is an annuity contract, a “special valuation rule” applies: you cannot use the fair market value of the account for the value of the annuity.

Background

Prior to August of 2005, annuity contracts were valued according to either their cash surrender value or current market value, if the back-end sales charge surrender schedule had expired. This method of valuation provided annuity carriers with the opportunity to try and artificially lower the value of their annuity contracts by assessing enormous surrender penalties in the first year or two of the contract. The participant (owner) would then convert the contract during this period so that the greatly reduced surrender value would be taxed instead of the current value of the contract.
Example: An insurer would levy a 20% surrender charge on a contract during the first year. IRA owners would then purchase an annuity inside their IRAs and convert them to Roth IRAs. A participant who purchased a $50,000 contract would only have to pay taxes on $40,000 after the 20% surrender penalty was deducted.

But the IRS eventually closed this loophole, issuing a temporary ruling against this practice that was eventually finalized. Annuity contracts inside Traditional IRAs are still valued according their cash surrender value, but there are now limitations on how much less that amount can be than its fair market value.

Current Valuation Rules

The IRS issued final regulations on the valuation of the annuity contracts in Roth conversions in July of 2008 (T.D. 9418). These regulations outline three separate methods that can be used to value annuity (fixed, index and variable) contracts for conversion purposes. They are listed as follows:

- **Surrender Method.** To the extent that an individual retirement annuity or an annuity contract held by an IRA is surrendered and no rights are retained or transferred the amount treated as a distribution is limited to the surrender value (the amount actually deposited into the Roth IRA);
- **Comparable Contract Method.** This type of valuation can be used for contracts where the participant (owner) purchased the contract at an earlier date and will receive a payout on the contract at some point in the future. Then the contract is valued at the fair market value of a comparable current contract with the same future payout schedule, assuming that the annuity carrier offers a contract that matches those parameters.

  Example: Assume that a participant purchases an annuity at age 50 and converts it to a Roth IRA at age 60. The contract is scheduled to pay the owner $1,000 per month beginning at age 65. The value of the contract at the time of conversion will be considered equal to the fair market value of a new contract from the annuity carrier that pays the same amount at age 70 that is purchased by a 60-year old. If the conversion is made within a short period of time of the initial purchase, then the actual value of the current contract is used instead;

- **Reserve Method.** This method is used if no comparable contract is available for the conversion in question. When this is the case, an interpolation is made of the contract's terminal reserves, and the fair market value of the contract is then based upon this amount; and
- **Accumulation Method.** This method is the simplest of the three methods, and is used only for annuity contracts that have not annuitized. This method simply takes into the account the accumulated value of the contract (known as the Entire
Interest calculation contained in Treas. Reg 1.409(a)(9)-6, Q&A -12), including any one-time sales charges or fees that were assessed over the prior year. Future distributions of any kind are disregarded under this method.

Guaranteed Benefit Riders

Owners of variable annuities with guaranteed living benefit riders may be in for a surprise when they convert their contracts to Roth IRAs. The net present value of the payout from an income rider is usually added to the value of the contract. The exact amount that is factored in is actuarially determined by the annuity carrier and will vary somewhat from one company to another as there are several methods of doing this. But it cannot be computed by the owner.

Owners of variable contracts with guaranteed riders of any kind should therefore expect the assessed value of their contracts to exceed the fair market value if the value of the contract has declined due to adverse market conditions.

Reporting to IRS

Regardless of the valuation method used, annuity owners can always rely on IRS Form 1099-R to report the correct amount for their Roth conversions. In most cases, this form will reflect one of the valuation methods described above. But those who are unpleasantly surprised by the amount reported on their tax form have the option to recharacterize their conversions before October 15 of the following year (see discussion below).

Recharacterizations

The tax code allows broad relief to taxpayers who wish to “undo” their IRA contributions by switching the regular annual contribution or conversion from a Roth IRA to a Traditional IRA or vice versa. This relief is called “recharacterization [IRC § 408A(d)(6)].”

Reasons to Do a Recharacterization

Anyone can do a recharacterization for any reason. After the recharacterization, the funds are treated as if they never left the IRA. Here are some of the reasons why a participant would consider a recharacterization:

- **Failed conversion.** Taxpayer converted a Traditional IRA to a Roth IRA and later found out that he/she could not qualify;
- **Bad Planning.** Taxpayer qualified but later found out that for planning purposes the conversion was not a good idea. For example, the taxpayer did not have the
funds available to pay the tax on the conversion. Or the additional income disqualified the taxpayer’s child from receiving financial aid in college; and

- **Market losses after conversion.** Taxpayer qualified for the conversion, and after converting the funds, the market value of those funds converted sustained significant losses, forcing the taxpayer to pay taxes on a much higher value (value at conversion).

**Recharacterization Requirements**

To recharacterize a contribution/conversion, the participant must have the contribution transferred from the Roth IRA back to the Traditional IRA (or vice versa) in a trustee-to-trustee transfer (plan-to-plan), not by an indirect transfer (60-day rollover). If the transfer is made by the due date (including extensions) for the tax return for the year during which the contribution was made, the participant can elect to treat the contribution as having been originally made to the Roth IRA instead of the Traditional IRA. If a participant recharacterizes their contribution, they must do all three of the following:

- Include in the transfer any net income allocable to the contribution. If there was a loss, the net income the participant must transfer may be a negative amount;
- Report the recharacterization on the participant’s tax return for the year during which the contribution was made; and
- Treat the contribution as having been made to the Roth IRA on the date that it was actually made to the Traditional IRA.

It is important to note if a participant receives a distribution from a Traditional IRA in one tax year and rolls it over into a Roth IRA in the next year, but still within the 60 days of the distribution from the Traditional IRA, it may be treated as a contribution to the Roth IRA in the year of the distribution from the Traditional IRA. Also, the recharacterization of a contribution is not treated as a rollover for purposes of the 12-month waiting period. This is true even if the contribution would have been treated as a rollover contribution by the second IRA if it had been made directly to the second IRA rather than as a result of a recharacterization of a contribution to the first IRA.

**Recharacterization Deadlines**

Generally, the deadline for recharacterizing a Roth IRA regular annual contribution or conversion is the due date of the tax return (April 15) for the year of the contribution that is being recharacterized, including extensions (October 15) [IRC § 408A(d)(6), (7)].

The taxpayer does not actually have to get an extension of his/her tax return in order to receive an extension beyond the tax filing date (April 15) for a recharacterization decision. That is because Treas. Reg. § 301.9100-2(b) provides an automatic 6-month extension (from April 15) for all “regulatory or statutory elections whose due dates are the due date including extensions provided the taxpayer timely filed his/her tax return for the year the election should have been made and the taxpayer takes the necessary steps” (discussed below).
Steps to Take for Recharacterization

In order to be able to do a recharacterization the taxpayer must complete the following necessary steps:

- File tax return by April 15 and pay any necessary taxes; and
- File IRS Form 4868 for a request for an extension.

Notifying the Custodians

Roth rules apply to all funds that are converted to a Roth IRA, including SEP IRA, SIMPLE IRAs, and employer plan funds. The custodians of both the Roth IRA (where the money currently is) and the Traditional IRA (where the recharacterized funds will go) must be notified in writing of the recharacterization. Although the custodian for both the Roth and the Traditional IRAs may be the same, they are often different institutions.

The recharacterized funds do not have to go back to the original account. In fact, if 401(k) funds were converted to a Roth IRA, they are recharacterized to a Traditional IRA, not back to the 401(k).

In all situations, the custodial notification must include the following six pieces of information:

- The type (“conversion” in this case) and dollar amount of the contribution (conversion) to the Roth IRA that is to be recharacterized. The number of shares and the specific assets that were converted are irrelevant for this purpose, as is the present value of those assets. What is important is only the value at the time the conversion took place. For a full recharacterization of a $200,000 conversion, the amount to be recharacterized is $200,000, even if the value is now only $20,000;
- The date on which the retirement funds were converted to the Roth IRA;
- A direction to the Roth IRA custodian to do a trustee-to-trustee transfer to the Traditional IRA custodian (reminder: assets can remain with the same custodian). As mentioned above, the recharacterization must be done as a trustee-to-trustee transfer. It cannot be done as a rollover (in-direct transfer). Clients can request that shares or specific assets be transferred back to the Traditional IRA. However, after doing the math for the net income calculation, it may not be the same number of shares that were converted in the first place;
- A direction to the Roth IRA custodian to transfer the amount of the conversion and any net income (or loss) allocable to the conversion. This is where the adjustment is made for the loss of value on the converted amount. The custodian should determine the gains or losses on the entire account balance and determine how much of that gain or loss is attributable to the conversion amount that is being recharacterized, but not all custodians will do the calculation; and
- The name of the Roth IRA and the Traditional IRA custodian (they may be the same). The recharacterization does not have to go back to the same IRA that it came from. It simply must go back to any Traditional IRA.
Note: Recharacterizations get a bit more complicated when the Roth IRA has other funds in it.

Example: Let’s assume Bill has $300,000 in a Traditional IRA. In July of 2016, he decided to convert 500 shares of Ace Company stock, worth $40,000, from the IRA to an existing Roth IRA with a balance of $120,000. By January 2017, those shares are only worth $10,000, and the account as a whole has decreased to $100,000.

Here’s how to calculate the net amount in a Roth recharacterization:

Step 1: $40,000 Converted amount of Ace Corp  
+ $120,000 Roth IRA balance the day before the conversion  
$160,000 Adjusted opening balance

Step 2: $100,000 Balance on the day before recharacterization  
$100,000 Adjusted closing balance

Step 3: $40,000  
$160,000 = 0.25 ratio

Step 4: $100,000 Adjusted closing balance  
- $160,000 Adjusted opening balance  
$60,000 Net account (losses)

Step 5: $(60,000) Net account (losses)  
x 0.25 Ratio  
$15,000 Losses (attributable to conversion)

Step 6: $40,000 Converted amount  
+ $(15,000) Earnings (losses) attributable to conversion  
$25,000 Amount to be recharacterized to Traditional IRA

Note: Recharacterizations are not treated as rollovers for purposes of the one-rollover per year limitations under IRC § 408(d)(3)(B).

Assets That Cannot Be Converted

It is important to note a tax-free rollover from an employer plan (or from another Traditional IRA) or a Traditional IRA may not be recharacterized as a Roth IRA conversion or contribution, because “an amount contributed to an IRA in a tax-free transfer cannot be recharacterized” [Treas.Reg. § 1.408A-5, A-10, Example 4].

Similarly, employer contributions to a SEP IRA or SIMPLE IRA may not be recharacterized as contributions to a Roth IRA, because the employer could not have made direct contributions to a Roth IRA in the first place [Treas. Reg. 1.408A-5,A-5].
But the employee may be able to convert (rollover) the SEP IRA or SIMPLE IRA to a Roth IRA.

Reconversion

Once a participant does a recharacterization he or she may be in a situation where it could be advantageous to do a reconversion. However, the IRS has placed various limits on the ability to use the recharacterization rules to flip back and forth between a Traditional IRA and a Roth IRA.

In Treas. Reg. § 1.408A-5, A-9, the IRS banned same year IRA-to-Roth IRA reconversions, effective in 2000 and later years. Once a recharacterization of an amount converted from a Traditional IRA to a Roth IRA occurs, a participant “may not reconvert that amount” to a Roth IRA until the taxable year following the taxable year of the original conversion, or until at least 30 days have elapsed since the characterization, whichever is later. If the participant defies this rule and attempts to reconvert before the prescribed time period ends, the result is a failed conversion.

Example: If a participant converts an amount from a Traditional IRA to a Roth IRA and then transfers that amount back to a Traditional IRA in a recharacterization in the same year, the participant may not reconvert that amount from the Traditional IRA to a Roth IRA before:

- The beginning of the year following the year in which the amount was converted to a Roth IRA; or, if later
- The end of the 30-day period beginning on the day on which the participant transferred the amount from the Roth IRA back to a Traditional IRA in a recharacterization.

Converting different money. The waiting period discussed above doesn’t apply if the taxpayer is converting different money. This could be money from a different IRA, for example. It can even be money in the same IRA from which you made the original conversion, if you converted only part of that IRA.

Time Line for Conversion, Recharacterization and Reconversion

What follows is a potential timeline for the conversion and recharacterization process.

Year One:

- Make a conversion before 12/31. Please note that many custodians require at least a week or two to process the paperwork for the distribution. Therefore, I would recommend the practical deadline to be 12/15 of year one to make the conversion.
**REMINDER:** The distribution must take place by 12/31 but the funding of the Roth IRA can be made after the year of the conversion.

For planning purposes, it is highly recommended that you do a Roth IRA conversion at the beginning of the year as opposed to the end of the year, to take advantage of the maximum “look-back” period to undo the conversion, if necessary. This gives the taxpayer an additional 11-months or so of hindsight.

**Year Two:**

- April 15: File tax forms, pay any taxes owed and file for an extension. This automatically extends the decision to make a recharacterization until October 15;
- October 15: This is the final deadline to “undo” undesirable Year One conversions and file by the close of the “automatic” extension period;
- November 16: This is the first opportunity to reconvert a recharacterized Traditional IRA (This could be done earlier if the recharacterization was done earlier than the October 15th deadline); and
- December 15: This is the last chance for initiating additional Roth IRA conversions for Year Two, assuming 16 days are needed to accomplish the conversion.

This timeline does not project beyond Year Two, but barring other tax law changes, the same logic would continue to apply for future years.

**DRAC to Roth IRA Rollover**

The DRAC to a Roth IRA is the third way to get funds into a Roth IRA. What is a DRAC? A DRAC is an option that is allowed to individuals who participate in a 401(k) or 403(b) plan after January 1, 2006. It is not a stand-alone retirement plan. It is governed by the same rules as other IRC §§ 401(k) and 403(b) plans.

**DRAC Contributions**

Contributions to the DRAC are made with after-tax dollars. The maximum amount of contribution to a DRAC is the same amount as allowed by the 401(k): $18,000 in 2017 (same as 2016). The catch-up contribution limit for age 50 and over in 2017 is $6,000 (same as 2016). The DRAC option does not increase the amount the employee may contribute to a plan through elective deferrals. Rather, the employee may choose to put his/her total permitted elective deferral into a DRAC, or into a “regular” 401(k) account, or partly to each. The total annual elected salary deferral contributions to a 401(k) including DRAC contributions are $18,000 in 2017 (same as in 2016).

The deferred amount to the DRAC is subject to the same income tax withholding as the employee’s take home pay, unlike deferrals to the 401(k), which are not taxed. However,
“qualified distributions” from the DRAC during the participant’s lifetime will generally be tax-free [IRC § 402A (d)(1)].

In contrast to a Roth IRA, there is no income ceiling above which an employee is not allowed to make designated Roth contributions [IRC § 402A]. There is no age limit above which the employee cannot contribute to a Roth 401(k). An employee can contribute to a Roth 401(k) even if he/she is also a participant in other retirement plans offered by the same or another employer.

**DRAC Rollovers**

IRS permits DRAC to Roth IRA rollovers that can be accomplished by either:

- *Direct Rollover* (trustee-to-trustee transfer) – the entire plan balance can go to an employer Roth plan or to an individual Roth IRA; or
- *In-direct Rollover (60-day rollover)* – only taxable amounts can be rolled over to another Roth employer plan or the entire plan balance can go to an individual Roth IRA and the rollover must be completed within 60 days.

Rollovers from a DRAC to a Roth IRA are permitted even if the participant is not eligible to make annual contributions to a Roth IRA or to convert his/her Traditional IRA to a Roth IRA. This means that a participant can establish a Roth IRA purely for the purpose of receiving a rollover of his or her DRAC, even if their income is too high to otherwise allow him or her to contribute to a Roth IRA.

If the employee does a partial 60-day rollover of a non-qualified distribution to his individual Roth IRA, the amount rolled into the Roth IRA is deemed to come first from taxable amounts distributed from the Roth 401(k). This means that the employee is rolling the taxable earnings portion into the Roth IRA first, and the balance of the distribution comes from the tax-free part (see Table 8.6).

### Table 8.6
**Allowable Rollovers from Roth 401(k)s**

<table>
<thead>
<tr>
<th>Rollover Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Direct Rollover</strong> (trustee-to-trustee transfer)</td>
<td>All or any part of the plan balance can go to another Roth 401(k), or Roth 403(b), if the receiving plan allows, or to a Roth IRA.</td>
</tr>
<tr>
<td><strong>Rollover to Employee (60-day rollover)</strong></td>
<td>All or any part of the balance can be rolled to a Roth IRA. Only taxable amounts (earnings) can be rolled over to another Roth 401(k) or Roth 403(b), if the receiving plan allows.</td>
</tr>
</tbody>
</table>
The Five-Year Holding Period for Qualified Distributions

Roth 401(k)s have their own “5-year holding rules.” Unlike individual Roth IRAs where there is only one 5-year period that starts with the establishment of the owner’s first Roth IRA, Roth 401(k)s have a separate 5-year holding period for each employer’s Roth account. If you work for two different companies and participate in the Roth 401(k) plan at each company, you will have two separate 5-year periods, one for each plan.

Also, the 5-year holding period is never carried over to an individual Roth IRA. The Roth 401(k) funds will be governed by the 5-year rule applicable to the Roth IRA. If the Roth IRA has already satisfied the 5-year period, then the employer funds are deemed to have also met the 5-year period, even if they were only in the Roth 401(k) for a year. This is just one more reason for qualifying individuals to establish a Roth IRA. If they don’t qualify this year, they will qualify in 2010 and later years when all the restrictions on converting to a Roth IRA are lifted and they can establish a Roth IRA by doing a conversion.

Roth IRA Documents Must Be Amended

On May 31, 2007 IRS released Announcement 2007-55 to remind Roth IRA sponsors that Roth IRA documents will need to be amended if they are to allow for the acceptance of rollover contributions from Roth 401(k) or Roth 403(b) accounts. All advisors working with clients who are thinking of rolling over Roth 401(k) balances to Roth IRA accounts should first be sure that the Roth IRA document allows for this type of rollover. A Roth IRA that has already accepted rollover contributions from a Roth 401(k) must have been amended by December 31, 2007 (Rev. Proc. 2002-10).

DRAC to Roth IRA Rollovers Allowed For High-Income Employees

The Worker, Retiree, And Employer Recovery Act of 2008 (WRERA) fixed a glitch created by Congress when they allowed direct rollovers from a qualified plan to a Roth IRA under IRC § 408A(e)(1)(B) beginning in 2008. In order to make clear that the income and filing status limitations on Roth IRA conversions also applied to these direct plan-to-Roth-IRA conversions, Congress provided that NO rollover to a Roth IRA from any eligible plan (other than a Roth IRA) was allowed if the taxpayer’s adjusted gross income exceeded $100,000 (or if the taxpayer was “married filing separately” under IRC § 408A(c)(3)(B).

Unfortunately Congress failed to notice that the way it had worded this section, NO money could be rolled from a QRP to a Roth IRA by an individual who exceeded the income limit (or was married filing separately, not even from a designated Roth account (DRAC), also referred to as a “Roth 401(k).” It was obvious that this made no sense because a rollover from a DRAC to a Roth IRA would not be a “conversion” of the rolled funds since they were ALREADY in a Roth-type account prior to the rollover.
WRERA fixed this glitch by adding the following sentence to IRC § 408A(c)(3)(B), effective for the years 2008 and 2009:

“...this subparagraph shall not apply to a qualified rollover contribution from a Roth IRA or to a qualified rollover contribution from a designated Roth account which is a rollover contribution described in IRC § 402A(c)(3)(A).”

Accordingly, a participant in a DRAC can now roll that money directly to a Roth IRA regardless of his or her income level or filing status.

**Small Business Job Protection Act of 2010**

Under Sections 2111 and 2112 of the Small Business Job Protection Act (SBJPA) of 2010, participants are allowed to make in-plan Roth conversions of their pre-tax employee contributions to 401(k) 403(b) and governmental 457 plans, effective for distributions made after September 27, 2010.

The in-plan Roth conversion provision was included in the Act because it is expected to raise more than $5.5 billion over the next 10 years from participants who perform in-plan rollovers to designated Roth programs. The implementation of this feature is discretionary.

**ATRA of 2102 Expands “In-Plan” Roth 401(k) Conversions**

The American Taxpayer Relief Act (ATRA) of 2012 (the "fiscal cliff" bill) allows employers to amend 401(k), 403(b) and governmental 457(b) plans to permit participants to convert pre-tax account balances to Roth account balances. Previously, such conversions were permitted only when the pre-tax amounts could be distributed.

**Background**

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act (ATRA) of 2012. The new law permits 401(k), 403(b) and governmental 457(b) plan sponsors to amend their plans to permit any amount under the plan to be converted to a Roth amount within the plan, even if the amount is not otherwise distributable. Converted amounts are treated as distributions and taxable in the year of conversion. The new law is effective January 1, 2013, but permits conversions of balances accumulated before 2013.

Prior to the new law, 401(k), 403(b) and governmental 457(b) plan sponsors could amend their plans to permit vested account balances to be converted to Roth amounts within the plan, but only if those amounts were otherwise distributable under the terms of the plan and qualified as eligible rollover distributions. This generally meant amounts were convertible only upon the participant’s severance from employment, death, disability or
attainment of age 59½ or, in the case of profit sharing or matching contributions, upon a stated age, stated event or fixed number of years, although traditional after-tax and rollover contributions and their earnings are generally freely distributable at any time. As under the new law, converted amounts were generally treated as distributions and taxable in the year of conversion (subject to a special rule for 2010).

Expansion of In-Plan Roth Conversions

Now, 401(k), 403(b) and governmental 457(b) plan sponsors may permit participants to make in-plan Roth conversions for any amounts held in the plan, regardless of whether they are otherwise distributable. A plan may (but is not required to) permit in-plan Roth conversions only if the plan is a 401(k), 403(b) or governmental 457(b) plan that has a Roth elective deferral arrangement. So, for example, a plan that consists only of profit sharing contributions would not be eligible to offer in-plan Roth conversions. If an eligible plan does not already have a Roth feature, it must add one to the plan before participants can be permitted to make in-plan Roth conversions.

Moreover, plans that currently permit Roth contributions must be amended if the employer wants to permit amounts that are not otherwise distributable to be converted to Roth amounts. As noted above, once the plan is amended, employees may convert amounts already in the plan to Roth amounts.

Once the plan has been amended to permit amounts that are not otherwise distributable to be converted to Roth amounts, the plan sponsor will need to set up and administer separate Roth accounts for participants who make conversions and don’t already have them. For participants who already have Roth accounts, the converted amounts would be transferred to the Roth accounts.

Note: Because the ATRA was signed into law so recently, there is not yet any IRS guidance on questions employers may have on establishing or administering this expansion of in-plan Roth conversions. Similarly, no “model” form of plan amendment has been circulated by the IRS. However, you can visit the IRS website to view FAQs on Designated Roth Accounts (http://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-on-Designated-Roth-Accounts).

Benefits to Participants

The ability to convert plan assets into Roth assets may be popular with plan participants because they can choose to convert plan assets into Roth assets and later take a tax-free distribution, provided the participant meets the requirements for a qualified Roth distribution (as was discussed above). Participants who are unsure about future tax rates or their future tax bracket can hedge their risks by converting some retirement plan assets into Roth assets and maintaining other assets as traditional pre-tax assets.
Conversion may be particularly appealing for participants who expect their tax rate to be higher when amounts are distributed, as well as those who are younger and whose accounts will have more time to grow after they are converted.

Converted amounts are not subject to the 10 percent early distribution tax under IRC § 72(t) of the Internal Revenue Code (generally applicable to distributions to participants under age 59½ that are not rolled over to an IRA or another qualified employer plan).

**IRS Notice 2014-54 After-Tax Rollover Rules**

IRS has issued new rules (IRS Notice 2014-54) for taking after-tax money out of a 401(k). Basically, if a participant has after-tax money in their 401(k) plan, they can now roll it into a Roth IRA where it will grow tax-free (as opposed to tax-deferred). The participant will not have to pay pro-rata taxes on the distribution, accounting for the percentage of the pre-tax money in their 401(k).

Here is an example of the new rules as spelled out in Example 4 of the IRS Notice:

"The employee’s 401(k) balance consists of $200,000 of pre-tax amounts and $50,000 of after-tax amounts (it does not include a Roth subaccount). The employee separates from service (i.e. quits, retires, or is fired) and requests a distribution of $100,000. The pre-tax amount of the distribution is $80,000 (four-fifths) and the after-tax amount of the distribution is $20,000 (one-fifth). The happy resolution: “The employee is permitted to allocate the $80,000 that consists entirely of pre-tax amounts to the Traditional IRA so that the $20,000 rolled over to the Roth IRA consists entirely of after-tax amounts.”

These new rules allow you to basically isolate your basis to do a tax-free Roth IRA conversion.

**Note:** The rules that say what portion of your distribution is pre-tax and what portion is after-tax have not changed. What’s changed is that you can now direct pre-tax dollars to one place and after-tax dollars to another. Before the new rule there was a convoluted way advisors accomplished this that required taxpayers to roll over the entire 401(k) and have outside funds on hand to counteract 20% income tax withholding. One potential gotcha: the distributions have to be scheduled at the same time, or they’ll be treated as separate distributions, and you’re back to square one, with each having a mix of pre-tax and after-tax dollars. But the IRS gives an allowance for “reasonable” administrative delays. The rules take effect January 1, but taxpayers can rely on them as of September 18, 2014 when they were issued. The IRS also has made relief for taxpayers who made this move in the past, using the roundabout method, based on a “reasonable interpretation standard.”
Chapter 8
Review Questions

1. Roth IRAs are defined under which Section of the Internal Revenue Code (IRC)?
   
   ( ) A. IRC § 401(k)
   ( ) B. IRC § 457(b)
   ( ) C. IRC § 408(A)
   ( ) D. IRC § 457

2. Which of the following statements about Roth IRAs is FALSE?
   
   ( ) A. Contributions to a Roth IRA are made with after tax dollars.
   ( ) B. Roth IRAs must be designated as such when set up.
   ( ) C. A Roth IRA can be either an account or an annuity.
   ( ) D. A SEP IRA and a SIMPLE IRA can be designated as a Roth IRA.

3. The $1,000 catch-up contribution is available to participants’ who reach age _____ by the end of the taxable year.
   
   ( ) A. 50
   ( ) B. 55
   ( ) C. 60
   ( ) D. 65

4. What is the maximum allowable contribution to a Roth IRA for a taxpayer age 50 and older in 2017?
   
   ( ) A. $6,500
   ( ) B. $6,000
   ( ) C. $4,000
   ( ) D. $5,500

5. If proper steps are taken, a taxpayer can “undo” or “recharacterize” a Roth IRA conversion up until which of the following dates?
   
   ( ) A. December 31st of the tax year of conversion
   ( ) B. April 15th of the tax year after the conversion
   ( ) C. October 15 of the tax year after the conversion
   ( ) D. October 1st of the tax year of conversion
CHAPTER 9

ROTH IRA DISTRIBUTIONS

Overview

As was discussed in Chapter 8, one of the major tax advantages of the Roth IRA is that during the participant’s lifetime he/she is not required to take required minimum distributions (RMDs). However, if the participant does take a withdrawal during his/her lifetime there are specific rules that must be followed to determine if the withdrawal was qualified or non-qualified. And upon the participant’s death, there may be required minimum distributions (RMDs), depending on who is named the beneficiary.

This chapter will review the rules pertaining to the distributions from Roth IRAs both during the participant’s lifetime and after the participant’s death.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Apply the rules pertaining to distributions from a Roth IRA during the participant’s lifetime, and for the required minimum distribution after the death of the participant;
- Identify the differences between a qualified and non-qualified distribution from a Roth IRA;
- Outline the requirements for a qualified and a non-qualified distribution from a Roth IRA;
- Observe the specific ordering rules when taking a non-qualified distribution from a Roth IRA; and
- Determine the 5-year holding periods for both Roth IRA contributions and/or Roth IRA conversions.

Participant’s Lifetime Distributions

When a Roth IRA participant takes a distribution from his or her Roth IRA, he or she must apply the following rules in order to determine the tax consequences, if any, of the distribution. The rules are:

- Qualified distribution rules,
- Non-qualifying distribution (ordering) rules,
• Conversion distribution rules, if applicable, and
• Earnings.

**Qualified Distributions**

“Qualified distributions” from a Roth IRA are not includable in the recipient’s gross income for federal tax purposes, regardless whether the recipient is the participant or a beneficiary [IRC § 408A(d)(1)(B)]. While a Roth IRA participant may request a distribution from his or her Roth IRA at any time, distributed earnings are exempt from taxes only if they are distributed as part of a “qualified distribution.” To be a qualified distribution, the distribution must meet both of the following events:

• The participant’s Roth IRA must have met the “waiting period” of five taxable years, also known as the “five-year non-exclusion period.” The Technical Corrections Act of 1998 (TTCA-98) defined the Roth IRA non-exclusion period as the five-taxable-year period beginning with the first taxable year for which the individual made a contribution of any kind to a Roth IRA [IRC §408A (d)(2)(B)] [Treas. Reg. 1.408A-6, A-2]. This rule eliminates the necessity of physically segregating Roth IRA contributory assets from conversion assets; and

• After meeting one of the following four qualifying events:
  o After the individual attains age 59½;
  o After the death of the individual;
  o On account of the total and permanent disability of the individual;
  o Made in a manner eligible as a qualifying first time home purchaser ($10,000 maximum lifetime limit).

**Example:** Computing the Five Year Waiting Period: On April 14, 2013 Tom invests $2,000 into his Roth IRA. Tom’s five-year period started January 1, 2012 and is completed on December 31, 2016. The first year in which he can possibly have a qualified distribution is 2017. If he makes further contributions (either regular or rollover) to the same (or any other) Roth IRA, those contributions DO NOT start a new five-year period running.

In 2017, Tom converts his $100,000 Traditional IRA to a new Roth IRA. This new Roth IRA instantly meets the five-year period requirement, because Tom has already completed the five-year period for every Roth IRA he will ever own. If Tom is already over age 59½, he can immediately take qualified distributions from his newly created Roth IRA.

**Non-qualified Distributions**

Distributions from Roth IRAs that are not qualified distributions are treated as made first from already-taxed dollars (i.e., contributions, rollovers and conversions). Therefore, until the total of all distributions from an individual’s Roth IRA exceeds the amount of
already-taxed dollars, the distribution(s) will not be includable in income. Also, for purposes of determining the tax treatment of IRA distributions, Roth IRAs and Traditional IRAs are treated separately.

**Ordering Rules**

The TTCA of 1998 amended IRC § 408A(d)(4)(B), thereby imposing strict “ordering rules” on distributions of Roth IRA contributions for tax purposes. First, the distribution ordering rules require a Roth IRA participant to treat all of his or her Roth IRAs as one. This is similar to, but separate from, the rule, which requires a Traditional IRA participant to treat all of his or her Traditional IRAs as one for determining the taxable portion of a distribution when the Traditional IRAs contain both deductible and nondeductible contributions. Then the Roth IRA distribution ordering rules require a Roth IRA holder to separately track Roth IRA assets according to three basic categories. The categories are:

- **Contributory Assets.** Contributory assets represent the total amount of assets contributed as regular Roth IRA contributions to all Roth IRAs of the participant up to the point of distribution;
- **Conversion Assets.** Conversion assets represent the total amount of assets converted from Traditional IRAs to Roth IRAs up to the point of distribution. The distribution ordering rules require the Roth IRA holder to identify all conversion assets by tax year of conversion, and further subdivide each tax year’s conversion amount into taxable pre-conversion assets (i.e., amounts which were pre-tax assets, such as deductible Traditional IRA contributions and eligible rollover contributions, held in the Traditional IRA prior to conversion) versus nontaxable pre-conversion assets (i.e., non-deductible contributions held in the Traditional IRA prior to conversion); and
- **Total earnings.** The amount of total earnings is the aggregate amount of earnings, which have accumulated on all Roth IRA contribution sources within all Roth IRAs. In other words, total earnings would be the aggregate value of Roth IRAs at the point of distribution, minus undistributed regular Roth IRA contributory amounts and conversions amounts.

Once the Roth IRA assets have been categorized by source, the distribution ordering rules require the Roth IRA participant to treat any amounts distributed as coming from the following sources in the following order listed:

- First, from contributory assets;
- Secondly, from conversion (rollover) assets, chronologically by tax year of conversion (i.e., first-tax-year in, first out), and, within each tax year’s conversion, taxable pre-conversion assets first, followed by nontaxable pre-conversion assets; and
- Finally, from total earnings.
Fortunately, the ordering rules will have to be consulted only in certain unusual situations namely:

- For most people, the *Ordering Rules* matter only for purposes of determining whether a non-qualified distribution is subject to income tax (see Table 9.1); the ordering rules essentially mean that the distribution is NOT taxable until all contributions have been distributed; and
- The ordering rules matter also for someone who converts a Traditional IRA to a Roth IRA before reaching age 59½, and then takes a distribution within five years of the conversion and before reaching age 59½. The ordering rules will apply in determining whether the 10 percent penalty applies to the distribution.

### Table 9.1
**Summary of Tax Implication of a Roth IRA Distribution**

<table>
<thead>
<tr>
<th></th>
<th>Qualified Distribution</th>
<th>Non-Qualified Distribution</th>
<th>Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No tax</td>
<td>No tax penalty</td>
<td>No tax</td>
</tr>
<tr>
<td><strong>Contributory Assets</strong></td>
<td>No tax penalty</td>
<td>No tax penalty</td>
<td>No tax penalty</td>
</tr>
<tr>
<td><strong>Taxable Pre-conversion Assets</strong></td>
<td>No tax</td>
<td>No tax penalty</td>
<td>No tax Penalty if within 5 years of conversion</td>
</tr>
<tr>
<td><strong>Nontaxable Pre-conversion Assets</strong></td>
<td>No tax</td>
<td>No tax penalty</td>
<td>No tax</td>
</tr>
<tr>
<td><strong>Earnings</strong></td>
<td>No tax penalty</td>
<td>Tax</td>
<td>Tax penalty</td>
</tr>
</tbody>
</table>

**Aggregation Rules.** For determining taxation of distributions the following Ordering and Aggregation rules will apply:

- All direct contributions for the same year are aggregated [Treas. Reg. §1.408A-6, Q&A-9(b)];
- Each rollover contribution is treated separately and successively on a first-in first-out (FIFO) basis for ordering withdrawals and assessing penalties [Treas. Reg. §1.408A-6, Q&A-8(a)(6)];
- All conversions within the same year are aggregated [Treas. Reg. §1.408A-6, Q&A-9(c)];
- All Roth IRAs are treated as one Roth IRA [IRC 408A(d)(4)(A)]; and
- All distributions from all of an individual’s Roth IRAs made during the year are aggregated [Treas. Reg. §1.408A-6, Q&A-9(a)].
In applying the Section 72(t) penalty, all Roth IRAs are treated as one Roth IRA and all distributions during the tax year are treated as one distribution and the value of the contract (IRA), income and investment are computed as of the close of the calendar year [IRC § 408(d)(2)].

All previous distributions, contributions, conversions must be known to determine how much remains of each category to correctly compute the taxation and penalties for the distribution.

5-Year Holding Period for Conversions

It is important to note that each Roth IRA conversion has its own “5-year holding period” which begins January 1 of the year of the conversion. However, a participant who is age 59 ½ or older does not need to worry about keeping records of the dates and amounts of conversions/rollovers. Such a participant can withdraw all conversions/rollovers as qualified distributions as long as 5-taxable years have passed beginning with the first year for which the participant made a Roth IRA contribution. Since the participant is 59 ½ or older, there is no 10% penalty tax.

Roth IRA Distributions after Participant’s Death

When the Roth IRA participant dies, the required minimum distribution rules that apply to Traditional IRAs will apply to the Roth IRAs as though the Roth IRA participant died prior to his or her required beginning date (RBD).

Distributions from an inherited Roth IRA generally must be entirely distributed by the end of the 5th calendar year of the Roth IRA participant’s death unless the interest is payable to a designated beneficiary over the life or life expectancy of the designated beneficiary. If there is more than one beneficiary, the oldest beneficiary’s life expectancy is used for the designated beneficiary. However, there are special rules for the spouse (discussed below).

Required minimum distributions are calculated for Roth IRAs separately from other IRAs. Required minimum distributions for plans other than a Roth IRA cannot be made from a Roth IRA, nor can required minimum distributions for Roth IRAs be made from other plans. Furthermore, where minimum required distributions can be made from another Roth IRA, required minimum distributions can be made from another Roth IRA only if the two Roth IRAs were inherited from the same decedent.

The required minimum distribution for each year is generally calculated by dividing the Roth IRA account balance as of the end of the previous year (12/31) by the life expectancy of the designated beneficiary. Life expectancies are based upon the RMD Single Life Table.
For a non-spouse beneficiary who inherits a Roth IRA, the account must be kept in the
decedent’s name, with the name of the beneficiary. Otherwise, it’ll be disqualified as a
Roth IRA, and the account will lose the potential for tax-free growth.

**Example:** Suppose that Mary Jones dies on January 1, 2017, and leaves her Roth
IRA to her son, Joe. Joe should tell the financial institution to rename, or re-title,
the Roth IRA this way: “Mary Jones Roth IRA (deceased January 1, 2017), FBO
Joe Jones, beneficiary.” This identifies the inherited Roth IRA as a beneficiary
Roth IRA (“FBO” means “For the Benefit Of”), and the account continues to
qualify as a Roth IRA.

**Spouse as Sole Designated Beneficiary**

A surviving spouse who is the sole designated beneficiary of the account has an
important advantage over any other beneficiary: the ability to do a rollover to a new Roth
IRA. This can be done most easily by “electing to treat the decedent’s Roth IRA as his or
her own,” thereby qualifying the surviving spouse for a lifetime exemption from RMDs.
Treas. Reg. § 1.408A-2, Q&A-4.

**Tax Reporting of Roth IRA Distributions**

While financial organizations must report Roth IRA distributions to the IRS based on
information gathered from completed withdrawal statements, the burden for determining
the tax consequences of a Roth IRA distribution lies with the Roth IRA participant or
beneficiary, except for the return of an excess contribution (plus earnings) before the
Roth IRA participant’s tax return due date. To assist the Roth IRA participant in
determining the taxability of a Roth IRA distribution, the IRS requires the participant to
file IRS Form 8606, *Non-deductible IRAs (Contributions, Distributions, and Basis)*.
Chapter 9
Review Questions

1. Which of the following statements about Roth IRA distributions is FALSE?

   ( ) A. Roth IRA participants are required to take distributions at age 70.
   ( ) B. RMD rules that apply to Traditional IRAs do not apply to Roth IRA participants.
   ( ) C. After the death of the Roth IRA participant, certain RMD rules that apply to a Traditional IRA also apply to Roth IRAs.
   ( ) D. During the Roth IRA participant’s lifetime they can take either a qualified or a non-qualified distribution.

2. Distributed earnings from a Roth IRA are exempt from taxes only if they are part of what type of distribution?

   ( ) A. Required distribution
   ( ) B. Qualified distribution
   ( ) C. Non-qualified distribution
   ( ) D. SOSEPP distribution

3. True or False. Each Roth IRA conversion has its own “5-year holding period” which begins January 1 of the year of the conversion.

   ( ) A. True
   ( ) B. False

4. Under the ordering rules, which of the following statements is FALSE?

   ( ) A. Roth IRA participant must treat all Roth IRAs as one.
   ( ) B. Contributory assets are always distributed tax-free first.
   ( ) C. Conversion assets must be distributed based on a FIFO basis.
   ( ) D. Distribution of earnings is always 100% tax-free.

5. To assist the Roth IRA participant in determining the taxability of a Roth IRA distribution, which IRS Form must be filed with the IRS?

   ( ) A. IRS Form 1009-R
   ( ) B. IRS Form 8888
   ( ) C. IRS Form 8606
   ( ) D. IRS Form 5329
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CHAPTER 10

IRA INVESTMENTS

Overview

This chapter will provide an in-depth review of the various investment providers and the different types of investments that may (and may not) be purchased inside an IRA. In addition, this chapter will also examine the benefits of having an annuity inside an IRA, the new DOL Conflict of Interest Rules, as well as the prohibited transaction rules.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Recognize various IRA providers and the types of investments offered inside IRAs;
- Observe the requirements and types of investments for a self-directed IRA;
- Determine investments that cannot be purchased inside an IRA;
- Offer the benefits of using an annuity inside an IRA;
- Relate the new DOL Fiduciary Rule and Best Interest Contract Exemption (BICE);
- Review the new requirements for calculating the fair market value of annuities inside an IRA under the “APV” rules for required minimum distributions; and
- Identify a prohibited transaction and the consequences of a prohibited transaction.

Investment Providers and Investment Types

Below is a list of the various investment providers that can provide individual retirement arrangements and the types of investments they can offer. The various types of institutions that can offer IRAs are:

- Banks;
- Insured Credit Unions;
- Brokerage Houses; and
- Mutual Fund companies.
Banks

Banks have traditionally offered IRA accounts with fixed-rate and variable-rate certificates of deposit, passbook accounts and money-market deposit accounts. These investments are protected by FDIC insurance, up to $250,000 per person, per bank. The fees, if any, charged for opening and maintaining an IRA are relatively small. Limitations on banks’ IRA deposit account products are discussed below.

Commercial banks may also market non-insured pooled-accounts and/or mutual funds for IRA customers, giving them a wider range of investment choices and flexibility. They may also provide other conveniences, such as transfers from checking accounts and direct payroll deductions.

There are essentially four ways a banking institution may invest IRA deposits:

- A time deposit open account;
- A certificate of deposit (CD);
- A passbook account; and
- Pooled or mutual funds.

Time Deposit Open Account

The term “time deposit account” has become virtually synonymous in current banking parlance with certificates of deposits (CDs). The Federal Reserve Board and the FDIC have issued regulations explaining how a time deposit open account must be established and maintained:

- IRA time deposit must be established by an agreement between the institution and the IRA trustee or custodian, and the time deposit account must be maintained separately from any other time deposit open account;
- Institution may market the time deposit with the interest at the prevailing rate for a three-year or longer maturity, for size of deposit, including amounts which would otherwise fall below the usual minimum for a time deposit open account;
- Although the time deposit is established for a set period of time, the funds on deposit at the end of that period do not need to be distributed. Rather, the depositor may leave the funds on deposit until age 59½ or later. During this period interest may still be credited to the time deposit at the prevailing rate;
- The penalties normally required for a withdrawal from a regular time deposit open account because of death, disability, or attainment of age 59½ are waived for an IRA time deposit, even though the withdrawal may occur within the maturity period; and
- The institution is permitted to make distributions from the time deposit in limited installments or as an annuity certain in lieu of a single lump-sum distribution. However, a provision for such a distribution must be contained in the IRA account agreement. During the payout period, the institution may continue to
credit interest to the balance in the time deposit at the same rate as it had been crediting prior to the commencement of the payout period.

**Special Certificates Of Deposit (CDs)**

Many financial institutions also offer a special form of certificate of deposit for IRA purposes. As with an IRA time deposit, the IRA certificate of deposit (IRA CD) must be specifically earmarked for IRA account purposes and purchased under the terms of an IRA account agreement. Furthermore, only IRA contributions may be used to purchase an IRA CD.

If an IRA participant makes periodic deposits to purchase the IRA CD, then each deposit made will purchase a separate CD for a separate period of time and interest rate. Thus, the participant would acquire a series of IRA certificates maturing at a series of dates. As a result, there must be a series of reinvestment “rollovers” into new certificates of deposit if the participant wishes to continue his or her contributions and IRA certificates through to age 59½ or later. Usually, the institution will automatically roll over the matured certificate unless otherwise instructed by the participant.

If at age 59½ or later, the IRA participant wishes to receive distributions in limited installments, the accumulated value of the certificates will need to be transferred into an IRA time deposit open account or some other investment vehicle which offers this type of payout.

**Passbook Accounts**

Most financial institutions continue to use a simple passbook account for IRA investment purposes. This offers the advantage of simplicity, but the interest rates that can be paid may be lower than the rates payable on other investment vehicles.

**Pooled Fund**

Under the Investment Company Act of 1940, a bank-pooled fund used for the assets of qualified plans and Keogh plans is exempted from registration. However, this exemption does not include a pooled fund for the assets of an IRA account. Thus, if the assets of the IRA account are to be included in a pooled fund, the fund must then register with the SEC (Securities and Exchange Commission) under the 1940 Act. Rather than register their pooled funds with the SEC, most banks have opted to use mutual funds—either through an arrangement with an existing fund family or by establishing funds of their own. (see “Mutual Funds” below.)
Insured Credit Unions

Insured credit unions also market accounts for IRA purposes, which are very similar to those marketed by banks and savings and loan associations. By law, the interest rate that insured credit unions are able to credit IRA accounts must be the same as the rate for all other types of accounts.

Brokerage Houses

Through “self-directed” IRAs, brokerage houses offer the widest range of investment alternatives. Some offer everything from money-market funds and stocks and bonds to public limited partnership interests.

The participant of such IRAs can change investments to enhance diversification or to pursue the best return. This offers a significant advantage over investing in bank certificates where a participant may be unable to dispose of the investment without facing interest penalties. Brokerage IRA accounts, however, do not offer the guaranteed return or safety that accompanies bank deposits.

Mutual Fund Companies

Mutual funds are popular choices for IRA accounts because they offer a wide range of investment objective alternatives. The IRA investor may move from one fund to another without tax consequences, and often without sales or administrative costs, depending upon the policies of the funds involved. Minimum contributions to set up an IRA at most mutual funds range from $25 to $500, while minimum subsequent contributions to add to an IRA are usually smaller amounts. Some funds also arrange to have contributions automatically withdrawn from the participant’s checking account and transferred into their IRA.

Mutual funds have become the dominant form of IRA investment. According to the Investment Company Institute (ICI), the mutual fund industry’s share of the IRA market was 47 percent as of the 4th Quarter of 2016, compared with 44 percent at year-end 2012 (see Table 10.1). Most mutual funds allow lower minimum purchase amounts for IRA contributions than for purchases in regular accounts in which facilitates monthly investments to take advantage of dollar cost averaging. Mutual funds are subject to securities laws that require that before shares are purchased, a prospectus should be given to the individual.

Under a custodial agreement, the custodian passes along to the individual any mutual fund notices, prospectuses, financial statements, proxies and proxy soliciting materials relating to shares in the IRA. The custodian typically charges an annual fee for its services in connection with the account. The custodian does not vote any of the shares in the account, except in accordance with the written instructions of the individual. If shares
in a unit investment trust are purchased, no plan completion insurance may be purchased by an IRA.

### Table 10.1

**IRA Assets By Type of Institution 1990 thru 2016**

(Billions of dollars)

<table>
<thead>
<tr>
<th>YEAR</th>
<th>Bank and Thrift Deposits¹</th>
<th>Life Insurance Companies²,³</th>
<th>Mutual Funds³</th>
<th>Other Assets³,⁴</th>
<th>Total IRA Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$266</td>
<td>$40</td>
<td>$138</td>
<td>$193</td>
<td>$637</td>
</tr>
<tr>
<td>1995</td>
<td>261</td>
<td>81</td>
<td>464</td>
<td>483</td>
<td>1,288</td>
</tr>
<tr>
<td>2000</td>
<td>252</td>
<td>203</td>
<td>1,233</td>
<td>942</td>
<td>2,629</td>
</tr>
<tr>
<td>2005</td>
<td>278</td>
<td>308</td>
<td>1,667</td>
<td>1,379</td>
<td>3,667e</td>
</tr>
<tr>
<td>2006</td>
<td>313</td>
<td>323</td>
<td>1,972</td>
<td>1,624</td>
<td>4,232</td>
</tr>
<tr>
<td>2007</td>
<td>340</td>
<td>336</td>
<td>2,241</td>
<td>1,831</td>
<td>4,747</td>
</tr>
<tr>
<td>2008</td>
<td>391</td>
<td>316</td>
<td>1,598</td>
<td>1,322</td>
<td>3,613</td>
</tr>
<tr>
<td>2009</td>
<td>431</td>
<td>323</td>
<td>1,953</td>
<td>1,544</td>
<td>4,251</td>
</tr>
<tr>
<td>2010</td>
<td>446</td>
<td>327</td>
<td>1,887</td>
<td>1,496</td>
<td>4,156</td>
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<tr>
<td>2011</td>
<td>482</td>
<td>358</td>
<td>2,199</td>
<td>1,833</td>
<td>4,872</td>
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<tr>
<td>2012</td>
<td>508</td>
<td>363</td>
<td>2,473</td>
<td>2,063</td>
<td>5,407</td>
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<tr>
<td>2013</td>
<td>507</td>
<td>412</td>
<td>2,959</td>
<td>2,643</td>
<td>6,521</td>
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<tr>
<td>2014</td>
<td>505</td>
<td>363</td>
<td>3,546</td>
<td>3,029</td>
<td>7,443</td>
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<tr>
<td>2015</td>
<td>523</td>
<td>387</td>
<td>3,498</td>
<td>2,920</td>
<td>7,329e</td>
</tr>
<tr>
<td>2016</td>
<td>561</td>
<td>411</td>
<td>3,719</td>
<td>3,159</td>
<td>7,850e</td>
</tr>
</tbody>
</table>

¹Data are preliminary. ²Bank and thrift deposits include Keogh deposits. ³Life insurance company IRA assets are annuities held by IRAs, excluding variable annuity mutual fund IRA assets, which are included in mutual funds. ⁴Category excludes mutual fund assets held through brokerage accounts, which are included in mutual funds. ⁵Data are estimated.  

**Note**: Components may not add to the total because of rounding.


### Self-Directed IRAs

“Self-directed” retirement plans limit the investments to a pre-selected group of choices. However, for those willing to pay higher maintenance fees, there are plans that offer such wide-ranging options as deeds of trust, real property, limited partnerships, commodities, over-the-counter and private securities, drilling, mining, timber rights and even precious metals. The only major prohibitions are collectibles and “self-dealing,” i.e., trading with oneself or family members, or use of entities in which one owns an interest (see Prohibited Transactions below).
The truly self-directed IRA account enables the IRA participant to decide on an acceptable degree of risk, make the desired investment and instruct the trustee when, or whether to dispose of those assets and purchase others. Profits from the sale of assets are returned to the plan and reinvested as desired.

The variety of options allows the IRA participant to conduct an extremely flexible long-term investment program. As the size of the account grows, there is the possibility of adding real estate, limited partnerships, mortgage loans and similar interests requiring larger amounts of cash. As retirement approaches, these riskier investments can be converted to more cautious investments that provide stable income for retirement purposes.

Whatever the terminology, the facts remain the same: All IRAs must adhere to the same IRS rules. The investment options available within an IRA are determined solely by the capabilities of the custodian sponsoring the IRA.

**REITs in IRAs**

Real-estate investment trusts—or REITs—are suddenly popular, largely because their often-hefty yields are treasured in a low-interest-rate world. REITs sport yields of nearly 4% lately. They also are perceived as being safer than some other investments.

A REIT owns and manages buildings, mortgages or other types of real estate and trades like a stock. REITs don't pay corporate taxes as long as they distribute at least 90% of their taxable income to holders.

**Note:** Before considering what type of investment account should hold a REIT, you need to consider what kind of REIT it is. Some REITs are traded on major stock exchanges while others are "nontraded" REITs. Traded REITs are easier for investors to buy and sell, while “nontraded REITs” are harder to trade and are only priced periodically by the sponsor.

When you think about REITs as an investment inside a Traditional IRA it is a kind of a wash in many ways. Generally speaking, the income you get from a REIT avoids corporate-level taxation, but is taxed as regular income when you receive it—a tax trade-off that lets you get larger distributions. If you put a REIT into a Traditional IRA, generally speaking, the nature of the income doesn't really change. It will get taxed as regular income either way.

That said, if you purchase a REIT in a traditional IRA, your client won't have to pay taxes on that income until they take money out of the IRA. If they own the same REITs in a regular brokerage account, they'll pay taxes in any year they receive distributions. So there is still a tax benefit to owning REITs in a Traditional IRA in that your client can defer the taxes they’d be paying on the income they receive. Things would even be better
for your client if they purchased the REIT inside a Roth IRA. For most REIT investments in a Roth IRA your client will not be paying taxes on the gains and dividends.

Be aware that some REITS may pay out “qualified dividends” that are taxed at the lower rate and/or non-dividend (which reduces cost basis). In other words, in a taxable account your client is probably not paying taxes. In a traditional IRA any benefit from non-dividend distributions is lost. The amount of such distributions is generally small, but it's an issue to consider when you look at where to own these securities. Also, some REITs (not all) may risk generating Unrelated Business Taxable Income (UBTI).

Note: Based on the DOLs new Fiduciary Rule all REITS sold within a retirement account (plan and/or IRA) will be subject to the Best Interest Contract Exemption (BICE), the contract must be between the financial institution and the retirement investor.

Annuities inside IRAs

For many years, fixed and variable annuities have been used extensively as funding vehicles for qualified retirement programs. In fact, according to Morningstar, at the end of 2015, 63% of annuity net assets were invested in qualified plans. With total annuity industry sales of $236.7 billion in 2015, the majority 68% were actually being purchased with funds sourced from a retirement account.

This is due to the favorable design of these products, which provides not only professional investment management of retirement assets, but also incorporates important insurance protections of assets and a future income stream.

The history of annuities in qualified plans is strong and clear, with the basis formed by Congress through statutory provisions in the Internal Revenue Code (IRC) of 1986:

- IRC § 401 – Qualified Pensions, Profit Sharing and Stock Bonus Plans
- IRC § 401(f) – Annuity Contract Shall be Treated as Qualified Trust
- IRC § 403(a) – Qualified Annuity Plan
- IRC § 403(b) – Annuity Purchased by IRC § 501(c)(3) Organization or Public School
- IRC § 408(b) – Individual Retirement Annuity
- IRC § 457 – Plans established for State and Local Government Employees funded with Annuities

It is clear from this legislation that the U.S. Congress has recognized annuities as a legitimate funding vehicle for qualified plans (including IRAs). It should also be noted that Congress provided specifically for annuity investments in tax-qualified plans well before the IRC of 1954 was enacted by funding these programs with fixed annuities.
The Double-Tax Deferred Question

Some argue that an annuity inside a qualified plan replicates the retirement plan’s built-in income tax-deferral feature and that such a transaction is unnecessary because the purchaser receives no benefit from this “double tax deferral.” The redundancy argument would have more validity if annuities offered income tax deferral as their sole benefit and if insurance carriers charged a fee for this same singular benefit. However, this is not the case.

The tax-deferred status afforded to annuity owners is not a benefit created by the issuing insurance companies; it’s the result of a congressional mandate. Decades ago, Congress declared that annuities may grow on an income tax-deferred basis. No insurance company issuing annuities has ever charged a fee for the income tax deferral provided by these products.

Since the “double tax deferral” redundancy costs nothing, and in many cases the annuity provides additional benefits, it seems unreasonable to claim that the buyer of an annuity within a qualified plan has somehow been misled.

However, over the years there have been a number of so-called financial experts who have made comments that investors should “never” purchase an annuity inside an IRA. Their reasoning: Annuities already come with a tax shelter, so there’s little point placing them inside other tax-sheltered investments. Those financial experts also argue that the only person who benefits is the agent selling the annuity because of the “high commissions” the agent will receive. Go visit: www.insurancelaw.com and read over 100 articles that date back to the late 70’s that question the ethical responsibilities of financial professionals who recommend annuities inside qualified plans and/or IRAs.

However, times have changed and certainly annuities have changed and of course many of those so-called experts have been changing their position on the benefits of annuities inside qualified plans and/or IRAs. The “old” argument against putting an annuity inside an IRA had been based primarily on the benefits of tax-deferral alone. Today annuities offer more than just tax-deferral, they offer a “safety net” with portfolio insurance and longevity insurance.

Advantages of Annuities inside an IRA

Some of the advantages of owning an annuity inside a qualified retirement plan and/or IRA that may debunk those critics are the following (please keep in mind that guarantees provided under an annuity contract are based on the claims-paying ability of the issuing insurance company and are not FDIC insured):

- **Guaranteed Death Benefit.** Annuities inside an IRA often guarantee the IRA participant (account owner) that regardless of what happens to the account value
held in his or her annuity, their beneficiary would receive the greater of the contract value minus withdrawals of the annuity at death, or the net value of contributions paid into the annuity. Several variable annuity issuers pay a death benefit that automatically adjusts or ratchets upward every few years (at an additional cost). Other issuers allow the IRA participant (account owner) to purchase a death benefit that is guaranteed to increase in value each year at a set rate (at an additional cost). These guaranteed death benefits ensure that the IRA participant’s beneficiaries will always receive at minimum, proceeds that will exceed net contributions made by the participant. In fact, FINRA has held that the death benefit offered by annuities may be an appropriate reason for placing an annuity inside a qualified retirement plan and/or an IRA;

- **Guarantees of Income for Life.** Annuities may provide the guarantee of income payments for the life of an individual or the joint life of two individuals, no matter how long the individuals live. With people living longer lives, this annuitization guarantee of income payments that cannot be outlived is increasingly important as individual’s fear of running out of money during their lifetime;

- **Guaranteed of Annuity Purchase Rates (Annuitzation).** Annuity contracts may also provide minimum annuitization payments for any given amount applied through contractually guaranteed initial annuity purchase rates. These minimum purchase rates are guaranteed at the time the contract is initiated and continue in force for the life of the contract, no matter what the changes are in economic conditions, life expectancies, interest rate climate, etc. At the time of inception, the IRA participant knows the very minimum rate, which could be paid upon annuitization at any time in the future, with the opportunity for higher payments based upon conditions when payments commence. The annuity’s annuitization benefit has been cited by industry regulators as appropriate reason for placing an annuity in a qualified retirement plan and/or IRA;

- **Investment Portfolio Choice.** Variable annuities typically offer a number of investment portfolios so that the IRA participant can choose those that are best suited to match their goals and tolerance for risk. Most variable annuities also offer a guaranteed fixed rate of return, which can be valuable for some plan participants. **Note:** Some fixed rate portfolios may be subject to a market value adjustment. Today, most variable annuities offer guaranteed living benefit riders to protect the annuity owner from the volatility in the market with “portfolio insurance;”

- **Expense Guarantee.** Variable annuity contracts guarantee that the mortality and expense risk charges and administrative fees within the contract will never be increased. This guaranteed lock on contract expenses becomes very meaningful over a 30–40 year period, which is typical of contract ownership, particularly when one considers how account and administrative fees have increased over recent years for other financial service products;

- **Guaranteed Living Benefits.** Guaranteed living benefits, optional riders on a growing number of variable annuities, create a variety of guarantees for investors while they are still living, as opposed to a variable annuity standard death benefit, which are really only guarantees for the investor’s beneficiaries. The growth of living benefits during the bear market years defined their success. Today, variable
annuities with guaranteed living benefits are becoming the norm, rather than the exception; and

- **Building/Replacing a Defined Benefit Plan.** Over the past few years there has been numerous reports talking about the changing retirement landscape and how retirees in the 21st century will need to build their own retirement plans. A new acronym has been developed: YoYo plans. Which stands for: You’re On Your Own. Gone are the days when an employee could depend upon their employer (defined benefit plans) and the government (social security) to retire for the “golden years.” For many new retirees, the largest retirement plan they may own may be their 401(k) plan. This defined contribution plan does not guarantee the income for life that a defined benefit plan would. Then it would seem logical that the opportunity would present itself for many of these retirees to rollover their qualified plan (401(k)) into an IRA and inside the IRA purchase an annuity. The annuity would accomplish all that a defined benefit plan would: Guaranteed income for life of the annuitant and/or his or her beneficiary.

These important guarantees provide real protection and benefits to the participant-owners who own an annuity inside a qualified plan and/or IRA. The tax deferral in the annuity is a matter of law—it is not a benefit provided by the insurance company, and there is no fee or charge for tax deferral.

A report by the Boston based research firm, Cerulli Associates, The Cerulli Edge—Retirement Edition, outlined the important role that the annuity will play in helping Americans convert their retirement savings to retirement income. As the report explains,

> “...whether the annuity is fixed or variable, deferred or immediate, no other financial product can offer a guaranteed, periodic income that will not run out during the lifetime of the investor or if chosen, the investor’s beneficiaries.”

The report highlights the potential candidates for the benefit of rollover annuities:

- “The new retiree who is ready to begin receiving a retirement income and is looking for an investment vehicle that guarantees an income stream for life;”
- “The recent job-changer seeking to protect the rollover amount plus a portion of future market appreciation;” and
- The new retiree or job-changer looking for an investment vehicle that will provide a guaranteed lifetime income stream in the future.”

**RMD Rules on Variable Annuity Contracts**

As was discussed in Chapter 6, a new IRS regulation, enacted back on January 1, 2006, has impacted calculations of required minimum distributions (RMDs) from variable annuity contracts.
The IRS has adopted revisions to Treas. Reg. §1.401(a)(9)-6 related to RMDs under deferred annuity contracts, effective June 15, 2004. This effective date was extended to December 31, 2005, to provide time for adjustments needed to comply with the regulations.

The primary change in the revised IRS regulation that impacts VA carriers involves the definition of “entire interest under an annuity contract.” Historically, the entire interest equaled the account value determined on Dec. 31 of the relevant valuation calendar year. The revised regulation now defines the entire interest in the contract as the account value plus the actuarial value of any additional benefits (in excess of the account value) provided under the contract. For VAs this is interpreted to mean that the actuarial value of any guaranteed minimum death benefits (GMDB) or any guaranteed living benefits (GLBs) must be considered when calculating RMDs.

The result of this new regulation will be increased RMD amounts that policyholders must be prepared to take on their VA contracts with enhanced benefits.

**Annuity Suitability Recommendations**

When recommending annuities as the underlying investment for a qualified plan (including an IRA), it’s very important that you understand what needs to be disclosed to your clients before recommending an annuity.

According to the FINRA Notice to Members 99-35 (go online at: www.finra.org), registered representatives (RR) must comply with four requirements when recommending variable annuities in a qualified plan and or IRA. They are:

- The RR should never sell a variable annuity to a client based solely on the product’s tax-deferral status;
- The investment must rest on one or more benefits provided by the variable annuity other than tax-deferral and that the RR inform the client that the variable annuity duplicates the tax-deferral already enjoyed by the client through his qualified plan/IRA;
- Besides discussing the benefits of variable annuities, the RR must fully discuss (disclosure) any potential limitations (such as surrender charges and illiquidity) or other material information (costs, IRS penalties, treatment of required minimum distributions) before recommending a variable annuity; and
- The RR should know, understand and record their clients’ financial background so they can better determine the suitability of recommending a variable annuity.

**DOLs New Fiduciary Rule**

Prior to the release of the Department of Labor’s (DOL) new Fiduciary Rule on April 6, 2016, annuities sold inside a qualified retirement plan and/or IRA were protected by the Prohibited Transaction Exemption (PTE) 84-24. However, under the new DOL Fiduciary
Rule, variable annuities (VAs) and fixed index annuities (FIAx) sold in a retirement plan and/or IRA will no longer qualify under the PTE 84-24. Firms and advisors making investment recommendations to retirement savers would now have to follow the new exemption, known as the Best Interest Contract Exemption (BICE) and the added *impartial conduct standards* as requirements for relief. The applicability date was April 10, 2017.

However, on March 2, 2017, in response to a February 3, 2017 presidential memorandum directing the DOL to re-examine the Fiduciary Rule, the DOL published a notice proposing a 60-day delay in the applicability date of the Fiduciary Rule. On April 7, 2017 the DOL promulgated a final rule delaying the applicability date of the Fiduciary Rule by 60 days from April 10, 2017 to June 9, 2017.

The April 7, 2017 rule also introduced a transition period regarding the exemptions associated with the Fiduciary Rule. Although exemptions would also become applicable on June 9, 2017 until January 1, 2018, fiduciaries relying upon the exemptions would have to only adhere to the “impartial conduct standards” to qualify for exempted relief.

The “impartial conduct standard” requires that advisers:

- Give advice that is in the “*best interest*” of the retirement investor;
- Charge no more than reasonable compensation; and
- Make no misleading statements regarding investment transactions, compensation or conflicts of interest.

In this context, “*best interest*” has two components:

- Prudence (i.e., meeting a professional standard of care); and
- Loyalty (i.e., the advice must be in the interests of the customer, rather than the advisor.

Although many practitioners expected the Fiduciary Rule to be further delayed or withdrawn, in an Op-Ed published on May 22, 2017 in the Wall Street Journal, the new Secretary of Labor Alexander Acosta wrote that the DOL could find “*no principal legal basis*” to change the applicability dates of its new Fiduciary Rule. Therefore certain provisions of the Fiduciary Rule will become applicable on June 9, 2017, with the remainder becoming applicable on January 1, 2018.

To view the DOL Fiduciary rule in detail go to:  
https://www.dol.gov/ebsa/regs/conflictsofinterest.html

**Note:** The DOL Fiduciary Rule does not apply to fixed annuity investments sold within qualified retirement plans and IRAs. The DOL Fiduciary Rule also contains a grandfathering provision which allows existing transactions to continue on their current commission basis.
Deduction of Fees inside an IRA

The IRS ruled in PLR 200507021 that the payment of wrap fees to a brokerage firm by the owner of an IRA using funds outside of the IRA will not be treated as a deemed contribution to the IRA. The unstated corollary to this holding is that the payments will be treated as expenses that are deductible under IRC §§ 162 or 212. This is true even though part of the fee is attributable to brokerage commissions.

The IRS ruled in Rev. Rul. 86-142 that brokerage commissions charged to an IRA that are not paid from the IRA, but from other assets of the taxpayer, are treated as contributions to the IRA, and are not deductible under IRC §§ 162 or 212.

In contrast, PLR 200507021 does not require taxpayers to treat any portion of the wrap fee in each of the five models as an addition to the IRA, not otherwise deductible under IRC §§ 162 or 212.

This PLR illuminates the view of the IRS regarding wrap fees. Wrap fees contain elements that are deductible and portions that are non-deductible under prior Revenue Rulings. It is a favorable ruling for taxpayers since it does not require the wrap fee to be split into its components in order to determine the tax consequences.

The PLR addresses only one issue as to each of the five service models: whether the payment of the wrap fee with funds outside of the IRA will be treated as a contribution to the IRA. The PLR does not determine whether the wrap fee is deductible.

Prior published rulings created a distinction between capital expenditures such as brokerage commissions and other plan expenses such as trustee’s fees, investment advisory fees and other administrative expenses. Brokerage fees are capital expenditures that are part of the cost of buying and selling securities. These are not deductible if paid from assets outside of the IRA and are treated as a deemed contribution to the plan.

The other costs of administering an IRA are deductible under IRC §§ 162 or 212 if paid from funds outside the IRA. Based on these prior rulings it is reasonable to conclude that the entire wrap fee will be deductible if paid from outside funds based on the analysis of the new PLR.

To Deduct or Not to Deduct: Should a participant pay the deductible IRA expenses from funds outside the IRA? Clearly yes, if the taxpayer receives a tax benefit from the deduction. However, if the IRA is a regular IRA not part of a trade or business, the expense will be deductible as a miscellaneous itemized deduction under IRC § 212. This deduction is only allowed to the extent it exceeds two percent of the taxpayer’s adjusted gross income (AGI) for the year. Further, this deduction is an add-back for alternative minimum tax (AMT) purposes. Thus, those participants who pay the alternative minimum tax will generally not receive any tax benefit for the amount otherwise deductible as an itemized deduction. If the IRA expenses can be attributed to a trade or
business, they can be deducted under IRC § 162, which eliminates the AGI threshold and AMT issues.

The answer is not as clear for a participant in AMT or for one whose miscellaneous itemized deductions do not exceed 2% of AGI. Although there is no current tax benefit from the payment, paying these expenses from within the IRA will reduce the amount that comes out of the IRA as taxable income in the future. However paying these expenses from outside funds permits more money to compound on a tax deferred basis. The decision regarding how to pay the IRA fees that are not deductible should be based on the investment choices for the outside funds, the expectations for investment earnings, the length of the deferral and the current and future tax rates. While it is hard to generalize, it probably takes at least a 20-year tax deferral to make it worthwhile to pay the IRA expenses with outside funds when no tax benefit is available from the deduction.

**Fixed Fee in Lieu of Brokerage Commissions**

The fifth and final business model presented in the PLR offers an alternative pricing option for full-service brokerage without any investment advisory services. Instead of paying brokerage commissions for each securities trade, the IRA participant can choose to pay a fee based on a percentage of assets in the IRA.

This part of the PLR gives the IRA participant an unexpected break. Even though the only service being provided for these fees is transaction costs, the IRS ruled that these fees are not deemed contributions to the IRA. This result is surprising since the brokerage commissions that the fees replace would be deemed contributions to the IRA under Rev. Rul. 86-142. The IRS was persuaded by the fact that the fees were calculated as a percentage of assets rather than on a transaction basis.

**Prohibited Investments in an IRA**

Because the law governing the types of investments permitted within IRAs is exclusive rather than inclusive, there is a specific list of investments that are prohibited (See IRS Publication 590 for complete details). These are:

- Collectibles (e.g. art, antiques, jewelry etc.);
- Life insurance;
- Coins (other than U.S. gold coins); and
- “Party-in-interest” transactions These are transactions involving “disqualified” parties such as ascendants, descendants, fiduciaries etc. [IRC § 4975 discussed below].

With these exclusions, the range of permitted investments is quite broad and includes mutual funds, stocks, bonds, annuities, certificates of deposit, private placements (LLC
memberships, LP interests, private C-Corp stock, and in the case of certain banks, S-Corp stock, etc.), promissory notes, trust deeds or mortgages, real property, and more.

**Investment in Collectibles**

Individuals are forbidden from investing IRA funds in collectibles. Under IRC § 408(m)(1) investments in collectibles are treated as a distribution from such account in an amount equal to the cost to such account of such collectible.

IRC § 408(m)(2) defines the term “collectible” to mean:

- Any work of art;
- Any rug or antique;
- Any metal or gem;
- Any stamp or coin;
- Any alcoholic beverage; or
- Any other tangible personal property specified by the Secretary.

The exceptions to this rule, under IRC § 408(m)(3), the term “collectible” shall not include:

- Any coin which is:
  - A gold coin described in paragraph (7), (8), (9), or (10) of section 5112(a) of title 31, United States Code;
  - A silver coin described in section 5112(e) of title 31, United States Code;
  - A platinum coin described in section 5112(k) of title 31, United States Code; or
  - A coin issued under the laws of any state.
- Any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness that a contract market (as described in Section 7 of the Commodity Exchange Act, 7 USC 7) requires for metals which may be delivered in satisfaction of a regulated futures contract, if such bullion is in the physical possession of a trustee.

The trustee or custodian may be a bank or any other entity who demonstrates to the satisfaction of the IRS that the manner in which they will administer the IRA account will be consistent with the requirements.

**Note:** A recent Private Letter Ruling (PLR 201446030) stated that the acquisition of shares of a trust invested in gold by either an IRA or an individually-directed account under a qualified retirement plan won’t be considered the acquisition of a collectible under IRC § 408(m). Thus, the amount invested won’t be treated as distributed under IRC § 408(m)(1).
Life Insurance inside an IRA

Life insurance is not permitted as a vehicle for an IRA investment [IRC § 408(a)(3)]. However, prior to November 7, 1978 life insurance contracts were permissible, and were sold to fund IRAs. For this reason, the original rules governing the “incidental life insurance” requirements in IRAs are still relevant.

Insurance contracts in individual retirement annuities are now limited to straight annuity contracts. However, prior to November 7, 1978, endowment contracts, having an incidental life insurance element were also permitted. Life insurance was deemed incidental if it did not exceed 100 times the monthly retirement income under the contract. The cost of the pure life insurance benefit is not tax-deductible [IRC § 219(b)(5)]. Therefore, for tax purposes, premium payments on pre-November 7, 1978 endowment contracts in individual retirement annuity plans must be separated into two elements:

- The life insurance element; and
- The savings element.

To determine the cost of the pure life insurance benefit the net amount of insurance must be calculated each year by deducting the cash value of the contract from the full death benefit. For this purpose, the cash value is determined at the beginning of the contract year, while the net amount of insurance at the end of the contract year is used. The cost of the insurance benefit is calculated by applying the one-year term premium (using the P.S. 58 Table) for the age at the end of the contract year to the amount of pure life insurance benefit.

Prohibited Transaction Rules

As was discussed in Chapter 1, with IRAs assets now exceeding $7.5 trillion in value, the wide availability of IRA custodians who permit investments in private placements, real estate and other non-publicly traded assets and the Department of Labor’s (DOL) recent promulgation of rules regulating IRA advisors, IRA owners and advisors need to be familiar with the IRA prohibited transaction rules.

A “prohibited transaction” (PT) is any of several actions listed in IRC § 4975(c)(1) that involves an IRA and a disqualified person (discussed below). To engage in a PT could result in the value of all profits in an IRA being taxed in the current year and a penalty imposed by the IRS (discussed below). Moreover, the IRA could no longer earn tax-free profits. Needless to say, it is important that the advisor carefully document all transactions and avoid a PT.

Disqualified Person

Under IRC § 4975(e)(2) an IRA “disqualified person” is any:
• Fiduciary [IRC § 4975(e)(2)(A)]; A fiduciary includes anyone who:
  o Exercises any discretionary authority or discretionary control over the IRA
    or exercises any authority or control over its assets; or
  o Provides IRA investment advice for direct or indirect compensation (or
    has any authority or responsibility to do so.

Because the IRA owner typically has investment discretion over the IRA, he/she
will be a fiduciary. A discretionary investment manager or compensated
investment advisor also will be a fiduciary. In April 2016, the DOL released its
final regulation redefining what counts as compensated investment advice for
determining fiduciary status, although the regulation doesn’t become applicable
until April 10, 2017;
• Person providing services to the IRA, such as an advisor, broker, custodian or
  accountant [IRC § 4975(e)(2)(B)];
• An employer any of whose employees are covered by the plan [IRC § 4975
  (e)(2)(C)];
• An employee organization any of whose members are covered by the plan [IRC §
  4975(e)(2)(D)];
• An owner, direct or indirect, of 50 percent or more of [IRC § 4975(e)(2)(E)]:
  o The combined voting power of all classes of stock entitled to vote or the
    total value of shares of all classes of stock of a corporation;
  o The capital interest or the profits interest of a partnership; or
  o The beneficial interest of a trust or unincorporated enterprise, which is an
    employer or an employee organization described above;
• A member of the family (the family of any individual must include his spouse,
  ancestor, lineal descendant, and any spouse of a lineal descendant. [IRC §
  4975(e)(2)(F)];
• A corporation, partnership, or trust or estate of which (or in which) 50 percent or
  more of [IRC § 4975(e)(2)(G)]:
  o The combined voting power of all classes of stock entitled to vote or the
    total value of shares of all classes of stock of such corporation;
  o The capital interest or profits interest of such partnership; or
  o The beneficial interest of such trust or estate is owned directly or
    indirectly, or held by persons described above;
• An officer, director (or an individual having powers or responsibilities similar to
  those of officers or directors), a 10 percent or more shareholder, or a highly
  compensated employee (earning 10 percent or more of the yearly wages of an
  employer) of a person described above [IRC § 4975(e)(2)(H)]; or
• A 10 percent or more (in capital or profits) partner or joint venture of a person
  described above [IRC § 4975(e)(2)(I)].

Prohibited Transaction Types

A “prohibited transaction” is any direct or indirect:
• Sale, exchange, or leasing of any property between an IRA and a disqualified person;
• Lending of money or other extension of credit between an IRA and a disqualified person:
  o This prohibition includes any guarantee in which the IRA is directly or indirectly the guarantor or the guaranteed party. An IRA owner’s guarantee of the obligation of a corporation in which the IRA invested was held to be an indirect guarantee so as to be prohibited. Cross-collateralization between one’s IRA and personal accounts also falls within this prohibition;
• Furnishing of goods, services, or facilities between an IRA and a disqualified person:
  o But as discussed below, an exemption permits a disqualified person to perform some services.
• Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan:
  o An impermissible use can arise in several ways. Use of perks generated by an IRA investment is one example. Securities purchased or sales by an IRA to manipulate their value to the advantage of the disqualified person also falls within this prohibition. But, mere co-investment by an IRA and a disqualified person is permissible, as long as the IRA investment isn’t made to enable or protect a personal interest, and the interests of the IRA and disqualified person do not conflict.
• Act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account;
  o This prohibition covers many of the actions falling under the transfer use prohibition. Neither will be violated merely because the disqualified person derives an incidental benefit from a transaction involving IRA assets, although whether a benefit is incidental may not always be clear.
• Receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan:
  o Although this prohibition is aimed at kickbacks, it can apply to a fiduciary’s receipts of gifts, entertainment or paid-for attendance at conferences. The IRS would view a loan broker’s receipt of loan fees from a borrower of an IRA loan to be prohibited, if the broker’s role in the loan rose to fiduciary status.

**Application of IRC § 4975**

The following plans are the type of plans to which the IRC 4975 excise tax provisions apply:

• A tax-exempt trust under IRC § 401(a) (which is part of a plan);
• A tax-exempt plan under IRC§ 403(a);
• An IRC § 408(a), Individual Retirement Account, or an IRC § 408(b), Individual Retirement Annuity (collectively, an IRA). However, if the individual for whom the IRA was established or the IRA’s beneficiary engages in a prohibited transaction with respect to the IRA, the sanction is the loss of the tax-exempt status of the IRA as of the first day of the taxable year in which the prohibited transaction occurs. See IRC §§ 408(e)(2)(A) and 408(e)(4); and
• Any of the above, even after they cease to be qualified. See IRC § 4975(e)(1)(G).

Note: In the late 1990s Congress, in different statutes, added Archer Medical Savings Accounts described in IRC § 220(d) and Education IRAs described in IRC § 530 to the plans described in IRC § 4975(e)(2). Both IRC § 220(e)(2) and IRC § 530(e) state that rules similar to those under IRC § 408(e) will be applied in the instance of these plans. This is also described at IRC § 4975(c)(4) and (5).

The excise tax provisions of IRC § 4975 do not apply to:
• A governmental plan within the meaning of IRC § 414(d); or
• Church plans that do not make an election under IRC § 410(d) to be covered by ERISA.

Penalty for IRA PT

In general, the penalty under IRC § 4975 generally starts out at 15% for most type of retirement plans; however, the penalty is harsher for self-directed IRAs.

IRA Holder/IRA Beneficiary Engages in a PT

When a self-directed IRA or Roth IRA participant (owner) or beneficiary is involved in a transaction that is deemed prohibited pursuant to IRC § 4975, pursuant to IRC § 408(e), the IRA loses its tax-exempt status and the IRA participant (or beneficiary) is treated for tax purposes to have received a distribution on the first day of the tax year in which the PT occurred. The distribution amount that the IRA participant is deemed to have received is equal to the fair market value of the IRA as of the first day of such tax year, and is required to be included in the IRA participant’s income for the year. In addition, unless the IRA participant qualified for an exception to the early distribution penalty (i.e. over the age of 59 ½, disabled, etc.), the 10% early distribution penalty would also apply.

Therefore, if the IRA participant or IRA beneficiary engages in a transaction that violates the PT rules set forth under IRC § 4975, the individual’s IRA would lose its tax exempt status and the entire fair market value of the IRA would be treated as taxable distribution, subject to ordinary income tax. In addition, the IRA participant or beneficiary would be subject to a 15% penalty as well as a 10% early distribution penalty if the IRA participant or beneficiary is under the age of 59 ½.
Non-IRA Holder or Non-IRA Beneficiary Engages in a PT

In the case where someone other than the IRA participant or IRA beneficiary (for example, another disqualified person) engages in a PT, that disqualified person may be liable for certain penalties. In general, a 15% penalty is imposed on the amount of the PT and a 100% additional penalty could be imposed if the transaction is not corrected.

Note: Fiduciaries to an IRA or plan are not subject to the 15% or 100% additional penalty.

Penalties for a PT under IRC § 408

The penalty for engaging in an IRC § 408 PT differs from the IRC § 4975 penalty. If an IRA assets are invested in collectibles or life insurance, only the assets used to purchase the investment are considered distributed, not the entire IRA.

In addition, pledging an IRA as a security for a loan is a PT under IRC § 408(e)(4). Under this section, if an IRA participant pledges a portion of his or her as security for a loan, only the amount pledged is deemed distributed – not the entire IRA.

The PT rules are extremely broad and the penalties extremely harsh (immediate disqualification of entire IRA plus penalty). Thus, the IRA participant self-directing his or her investments must be especially cautious in engaging in transactions that could compromise his or her best judgment or result in a direct or indirect personal benefit. Accordingly, it is crucial that any retirement investor looking to make an investment involving retirement funds work directly with a retirement tax professional or qualified tax advisor to make sure that the proposed transaction would not violate any of the IRS PT rules.
Chapter 10
Review Questions

1. Which of the following CANNOT be a custodian of an IRA?

( ) A. Banks
( ) B. Insurance companies
( ) C. Individuals
( ) D. Brokerage firms

2. Which of the following is the most popular investment choice inside an IRA?

( ) A. Stocks
( ) B. Annuities
( ) C. Real estate
( ) D. Mutual funds

3. Which of the following is NOT a prohibited investment inside an IRA?

( ) A. Annuities
( ) B. Life insurance
( ) C. Collectibles
( ) D. Coins

4. Prohibited transaction rules are governed under which Section of the Internal Revenue Code (IRC)?

( ) A. IRC § 5329
( ) B. IRC § 401(a)(9)
( ) C. IRC § 4975
( ) D. IRC § 2518

5. What is the tax imposed on each prohibited transaction?

( ) A. 10%
( ) B. 15%
( ) C. 25%
( ) D. 50%
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CHAPTER 11

IRA CREDITOR PROTECTION

Overview

With IRA assets becoming an increasingly significant portion of many of your clients’ assets and estates, in situations in which creditor protection for the participant and his or her beneficiaries is a concern, advisors need to be aware of the potential asset protection issues presented by both IRAs (including Roth IRAs) and inherited IRAs.

This chapter will provide a review of the federal and state creditor protection laws of qualified retirement plans and IRAs, as well as the recent federal changes enacted by the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) of 2005. At the end of the chapter, it will examine the myriad of the various state laws pertaining to the creditor protection of IRAs (including Roth IRAs) and Inherited IRAs.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Apply the rules and regulations affecting qualified retirement plans and IRAs under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005;
- Understand creditor protection for retirement funds outside of bankruptcy;
- Review the rules for creditor protection of IRAs and Roth IRAs;
- List states that have full protection of IRAs and those that do not; and
- Identify possible creditor protection issues with Inherited IRAs.

Federal Bankruptcy

In federal bankruptcy proceedings, the debtor’s assets are pooled in his/her “bankruptcy estate.” And, then those assets will be divided among his/her creditors. There are two ways an asset can escape the process and stay out of the hands of the creditors:

- Method A: Keep the asset out of the bankruptcy estate altogether. The bankruptcy estate includes “all legal or equitable interests of the debtor in property.” [11 USC § 541(a)(1).] If, the asset never gets into the estate, it’s not available to creditors; and
Method B: Qualify for an exemption. Certain assets, even though they are property of the debtor, are exempted. An exempt asset is removed from the bankruptcy estate, remains the property of the debtor, and it is not available to his creditors.

Bankruptcy Estate Defined

Under the Patterson v. Shumate case the Supreme Court ruled that ERISA plans are not included in the bankruptcy estate. In this crucial determination of whether an asset is or is not included in the debtor’s bankrupt estate, 11 USC § 541(c)(2) provides that:

“A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.”

This translates into an asset that is:

- Held in trust; and
- Subject to an enforceable non-bankruptcy law restriction on transfer does not become part of the debtor’s estate.

Another name for a “restriction on transfer” is “spendthrift clause”: a provision in a trust that says the beneficiary cannot assign or otherwise currently cash in his/her interest in the trust.

ERISA Section 206(d)(1) states that every pension plan covered by ERISA:

“...shall provide that benefits provided under the plan may not be assigned or alienated.” [29 USC Section 1056(d)(1).]

The Supreme Court ruled way back in 1992 that this ERISA-required “anti-alienation clause” in a qualified pension plan is an enforceable non-bankruptcy law restriction on transfer within the meaning of 11 USC Section 541(c)(2). [Patterson v. Shumate, 504 U.S. 753 (1992).]

Solo Business Owners

Unfortunately, not all qualified plans are protected by the Patterson v. Shumate holding. Ingenious creditors have successfully argued that ERISA’s anti-alienation clause applies only to “employee benefit plans.” Under a Department of Labor (DOL) regulation, for purposes of determining whether a retirement plan is covered by Title I of ERISA, an individual and his spouse are not deemed to be “employees” with respect to any business wholly owned by either or both of them, and a partner and his spouse are not “employees” of the partnership. [29 C.F.R. Section 2510.3-3.]
Therefore, a retirement plan that has no members other than such a business owner (or partners) and his (or their) spouses is not an “employee benefit plan” (because it covers no “employees”) and therefore is not subject to ERISA’s anti-alienation clause requirement, and is not excluded from the bankruptcy estate under Patterson v. Shumate.

However, if the plan also covers one or more other employees (in addition to the business owner, partners, and/or their spouses), then it IS an employee benefit plan under ERISA, and the sole business owner, partners, and/or their spouses who are in the plan ARE considered “employees” and “plan participants” for all ERISA purposes! Thus, the business owner whose company’s qualified plan has no participants other than the business owner himself and/or his spouse gets no protection whatsoever from Patterson v. Shumate.

The good news (for debtors) is that the new BAPCPA exemption (below) makes no distinction between business-owner plans and other qualified plans; the exemption now turns on tax-qualified status rather than ERISA status. Thus, the BAPCPA exemption is great news for business owners, partners, and their spouses who have money in retirement plans that do not happen to have any other participants.

**Qualify Assets for an Exemption**

Certain assets, even though they are property of the debtor, are exempted. An exempt asset is removed from the bankruptcy estate, remains the property of the debtor, and is not available to his/her creditors.

But even the exemptions are not simple. And in fact, there are two sets of exemptions:

- Set 1: the “USC § 522(d) exemptions;” and
- Set 2: the “USC § 522(b)(3) and state law exemptions.”

**Note:** The section numbering reflects amendments made by BAPCPA (discussed below). Under pre-BAPCPA law, the debtor’s choice is also between the USC § 522(d) (federal bankruptcy) exemptions and his/her state-law-plus-some-federal exemptions but the latter are in USC § 522(b)(2), not USC § 522(b)(3).

The debtor must choose one set (federal) or the other (state). Sometimes, however, he/she has no choice: If he/she does not, in the period preceding the bankruptcy filing, been domiciled in any state long enough to be entitled (under federal bankruptcy law standards) to use such state’s exemptions, he/she is limited to the USC § 522(d) exemptions. 11 USC § 522(b)(3), as amended by § 307 of BAPCPA.

If he/she is properly domiciled (for federal bankruptcy purposes) in a state that requires them to use the “USC § 522(b)(3) plus state law” list, he/she must use that set. [11 USC § 522(b).]
So which set of exemptions is better for a debtor who is trying to shelter retirement benefits? Prior to BAPCPA, the answer to that depended on which state the debtor lived in. Some states have great exemptions for IRAs (and other retirement plans not covered by Patterson v. Shumate) while other states’ IRA exemptions are meager or nonexistent. Since the federal bankruptcy exemption for retirement benefits required, pre-BAPCPA, a showing of need (see below) a debtor who lived in a state with more generous state exemptions would probably choose the state law exemptions.

On the other hand, for a debtor whose state gave little or no shelter to retirement benefits, the need-based USC § 522(d)(10)(E) exemption would be “better than nothing.”

After BAPCPA, the choice between the two sets of exemptions will, for most, if not all debtors, turn on factors other than the protection of their retirement benefits. As a result of BAPCPA, ALL types of tax-favored retirement plans will be sheltered by the same broad federal exemption regardless of whether the debtor uses the USC § 522(d) exemptions or the USC § 522(b)(3)-plus-state-law exemptions.

IRAs in Bankruptcy Proceedings

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) if a creditor obtained a judgment for an unpaid debt, and if the debtor filed for protection under the federal bankruptcy laws, only qualified retirement plan accounts and not IRAs were protected from the creditor’s claims. IRAs were not protected under federal law. Many states have laws exempting IRA accounts from creditor claims, but these state laws may be pre-empted by federal law.

ERISA Protection Not Applicable to IRAs

The ERISA provision protecting qualified plan accounts is applicable to any employee benefit plan described in ERISA § 1003(a), other than “an individual retirement account or annuity described in [IRC § 408 [29 USC 1056(d)(1)].” This, of course, means that IRAs, including SEP IRAs under IRC § 408 (k), unlike employer-sponsored qualified plans, are not shielded from creditor claims under federal law. Employer-sponsored qualified plans, like 401(k) plans, for example, are fully exempt because they are shielded from creditors by ERISA. With IRAs, on the other hand, the extent of bankruptcy protection was less clear; it is an amalgam of federal and state law that depends on the debtor’s state of residence.

Since the ERISA provision restricting alienation of a qualified plan account is not applicable to IRAs, the status of IRAs in bankruptcy proceedings was unsettled at best until 2005. The best analysis had it that IRAs are protected in bankruptcy only for debtors domiciled in states having statutes shielding IRAs from creditor claims generally (i.e., outside of bankruptcy), relying on the exclusion from the bankruptcy estate of property of the debtor that is subject to a restriction on transfer enforceable under
“applicable non-bankruptcy law.” See 11 USC § 541(c)(2) of the Federal Bankruptcy Code which excludes from the bankruptcy estate property of the debtor that is subject to a restriction on transfer enforceable under “applicable non-bankruptcy law.” The United States Supreme Court settled the question, if not all of its ramifications, in Rousey v. Jacoway, No. 03-1407 (Apr. 4, 2005), holding unanimously that IRAs are exempt in bankruptcy proceedings. Instead of invoking § 541(c)(2), the Rousey’s relied on 11 USC § 522(d)(10)(E), which provides in relevant part that:

“...a payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor...may be exempted from the bankruptcy estate.”

Rousey v. Jacoway

Richard and Betty Jo Rousey of Berryville, Arkansas, were participants in employer-sponsored pension and 401(k) plans. Richard took early retirement in 1998. Betty Jo’s employment was terminated by her employer, Northrup Grumman, a month later and she was required to withdraw funds from the company’s pension plan.

All the Rousey’s retirement funds were rolled over into IRAs. After employment terminated, Mr. and Mrs. Rousey had difficulty in securing and maintaining employment, partially due to physical disabilities.

Several years after establishing their IRAs, the Rousey’s filed a joint Chapter 7 Bankruptcy Petition in the U.S. Bankruptcy Court for the Western District of Arkansas. The Rousey’s attempted to shield their IRAs from creditors by claiming them exempt from the bankruptcy estate under the Bankruptcy code sections which are applicable to stock bonus, pension, profit sharing, annuity, or similar plans and because the funds were reasonably necessary for the support of the Rousey’s and their dependents.

The Bankruptcy Trustee objected to the Rousey’s exemption claim. The Bankruptcy Court ruled that the IRAs were not protected. The Rousey’s appealed. The Eighth Circuit affirmed the Bankruptcy Court concluding that “even if the Rousey’s IRAs were ‘similar plans or contracts’ to stock bonus, pension, profit sharing or annuity plans, their IRAs gave them no right to receive payment on account of age.” The Court of Appeals stated that the IRAs were “readily accessible savings accounts of which the debtors may easily avail themselves (albeit with some discouraging tax consequences) at any time for any purpose.”

The Rousey’s appealed to the U.S. Supreme Court. Certiorari was granted because of inconsistent rulings in the circuits. The question was whether an IRA is a “similar plan or contract” to those specified in the statute. The Court of Appeals for the Eighth Circuit held that they are not, because unlike the specified plans an IRA holder has “unlimited” or “unfettered” access to the funds; IRAs are “readily accessible savings accounts of
which the debtors may easily avail themselves (albeit with some discouraging tax consequences) at any time for any purpose.” It also held that payments were not, as the Rousey’s contended, “on account of” age.

The Supreme Court unanimously reversed. It held, contrary to the Eighth Circuit, that the 10 percent addition to tax for withdrawals before age 59½ is a substantial limitation on their rights, effectively preventing access to the entire balance of their IRAs, so that the removal of that restriction upon their attaining 59½ means that their right to their money is a right “on account of age.” The Court also found that IRAs are “similar” to the plans enumerated in the statute in that all are meant to substitute for wages earned as salary or hourly compensation.

Several points should be noted. First, the Supreme Court did not address the statute’s “reasonably necessary” requirement. Thus, it may be that IRA assets even after Rousey can be part of the bankruptcy estate to the extent they exceed what is “reasonably necessary” for the debtor. Second, Rousey depends on the interpretation of a federal bankruptcy exemption, which might be accepted or rejected by individual states. If a debtor’s state has rejected the federal exemptions, Rousey does not apply and the debtor is thrown back on whatever protections state law affords. Some states agree with the Eighth Circuit, stating state laws are not uniform on this issue. Some take the view that IRA accounts are essentially not much more than savings accounts, voluntarily established and at all times under the control of the IRA participant (account owner); therefore, they should be accessible to judgment creditors. Other jurisdictions include IRAs in a class of property that is specifically exempted from levy by judgment creditors. However, even in states that provide such an exemption, the exemption will not apply to shield IRAs from IRS liens or levies for unpaid taxes. Finally, Congress could easily vitiate Rousey, for example by repealing the 10 percent addition to tax.

**Bankruptcy Abuse Protection and Consumer Protection Act of 2005 (BAPCPA)**

The “Bankruptcy Abuse Protection and Consumer Protection Act of 2005” (called “BAPCPA” for short) enacted by Congress in April 2005 and signed into law on April 20th created a broad new federal exemption for tax-qualified retirement benefits. This new exemption eliminates many of the distinctions that once helped creditors seize debtors’ retirement plans. Bankruptcy USC § 522(b)(3)(C) now provides that “retirement funds” are exempt in bankruptcy.

The new exemption explicitly applies to IRAs, Roth IRAs, 457 plans, 401(a) plans, and 403(b) plans. So it covers much more than just “ERISA” plans. The exemption eliminates the distinction between “solo business owner” plans and other qualified plans (the distinction that undermined the Patterson v. Shumate Supreme Court holding).

The exemption is available regardless of whether the debtor uses his state law exemptions or his federal bankruptcy exemptions. The exemption narrows (closes?) the loophole that
enabled creditors to attack the tax qualification of pension plans as a way of tossing out the exemption. And unlike the old § 522(d)(10)(E), the new exemption does not require the debtor to show “need” for it to apply.

Ironically, while BAPCPA in general clamps down on debtors’ excessive or abusive use of exemptions (for example, by limiting the exemption for a “homestead” if purchased in defraud of creditors within 10 years prior to bankruptcy (BAPCPA § 308), and by specifying that “household goods” may not include more than $500 worth of jewelry (BAPCPA § 313), BAPCPA throws the door wide open to “excessive” use of the retirement benefits exemption.

**IRA Exemptions Following BAPCPA**

The BAPCPA exemption provided a cap on the amount of funds that can be protected from creditors of retirement benefits in Traditional IRAs and/or Roth IRAs. The maximum amount of retirement funds was set at $1 million indexed with future cost of living as of April 1 every three years (IRC § 104). In April 1, 2016, the exemption cap amount was increased from $1,245,475 to $1,283,025 through March 31, 2019, without regard to amounts attributable to rollover contributions, and earnings thereon.

However, this limitation applies ONLY to Traditional and Roth IRAs, and does NOT apply to Simplified Employee Pensions (SEP) IRAs under IRC § 408(k) and Saving Incentive Match Plans (SIMPLE) IRA accounts under IRC § 408(p) [11 USC Section 522(n), added by § 224(e) of BAPCPA.].

Thus, to compute the debtor’s combined exemption for all of his IRAs and Roth IRAs, apparently you would:

- First, determine the amount of his/her rollover contributions and the earnings thereon (by some type of tracing or apportionment procedure that has not yet been spelled out), all of which would be exempt, and add to the exempt pile (possible reason why you may want to keep IRA rollovers in a separate IRA); and
- Then, count another $1,283,025 attributable to contributions other than the specified types of rollover contributions and earnings.

If there is still more money in the account, the excess is not exempt. Note the following:

- For qualified plans, IRC § 403(b), and IRC § 457 plans, the exemption is unlimited in amount, with no distinction between rollover contributions and any other contributions. This lack of a ceiling creates an incentive for debtors with large IRAs to roll their IRAs into qualified plans, IRC § 403(b), or IRC § 457 plans (or keep their funds in such plans);
- If the “interests of justice” so require, the $1,283,025 cap may be raised, presumably on a case-by-case basis. A debtor might argue that, in order for there to be true parity between Roth IRAs (which constitute wholly or largely after-tax money) and Traditional IRAs (which constitute wholly or largely pre-tax money),
“in the interests of justice,” the cap should be raised higher for Traditional IRAs to equal the pre-tax equivalent of $1,283,025 after taxes;

- This limitation revives the incentive for keeping IRAs that are funded with rollover contributions separate from IRAs funded with annual contributions. EGTRRA had made this distinction obsolete (temporarily, it turns out). If the debtor has a pure rollover IRA, and a pure annual-contributions IRA, he/she can spend down the annual-contributions IRA prior to bankruptcy so it will be under $1,283,025 cap, while allowing his/her rollover IRA to grow to the sky fully sheltered by the unlimited exemption. For those who have combined their annual-contributions and rollover IRAs, there is now no known way to unscramble them (though future rollover and annual contributions could be made to separate accounts, to make tracing easier);

- “Rollover contributions” are defined by specific Internal Revenue Code (IRC) Sections, namely: IRC § 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8). These sections deal with distributions from qualified plans and 403(b) plans. Rollovers of 457 plan distributions presumably also qualify, because IRC § 457(e)(16) incorporates the rollover rules of IRC § 402(c). On the other hand, a rollover from one IRA to another IRA is tax-exempt under IRC § 408(d)(3), which is not a listed section. Thus, an IRA-to-IRA rollover does not turn the rolled funds into a rollover contribution for purposes of the limitation;

- On the other hand, if funds in an IRA are attributable to a rollover from a qualified (or § 403(b) or § 457) plan, such attribution presumably survives subsequent IRA-to-IRA rollovers;

- A surviving spouse can roll a distribution from the deceased spouse’s qualified retirement plan into the surviving spouse’s own IRA under IRC § 402(c)(9). This should count as a rollover contribution to her IRA for purposes of the limitation since it is under one of the listed sections, namely, IRC § 402(c). It is not clear how a decedent’s IRA which the surviving spouse elects to treat as her own under Treas. Reg. § 1.408-8, A-5, would be treated: Is it the surviving spouse’s own retirement plan for purposes of the exemption or is it an inherited IRA? If it is treated as the spouse’s own IRA for purposes of the exemption, presumably we look back at the decedent’s track record to determine whether the funds are attributable to rollovers from qualified, 403(b), or 457 plans. Or, is the decedent’s record erased by the spouse’s election, so that none of the IRA is deemed attributable to such rollovers?

- If the debtor has elected his state exemptions, and his state gives an unlimited exemption to IRAs, it is not clear to me whether the 11 USC Section 522(n) rollovers-plus-$1,285,023 cap limitation applies only for purposes of the federal USC § 522(b)(3) exemption or whether it also overrides the state exemption; and

- For now, the $1,283,025 cap will likely affect few debtors (other than by forcing them to prove rollover contributions if their IRAs exceed $1,283,025). For most debtors, the limit will be more than enough to fully shelter their IRAs for many years to come.
Post-BAPCPA Results

USC § 522(d)(10)(E) will presumably be of interest only to someone who:

- Has elected to use the USC § 522(d) exemptions;
- Has, in his/her IRAs and Roth IRAs, more than $1,283,025 that is attributable to non-rollover contributions; and
- He/she can demonstrate that the excess amount is needed for the support of himself and his dependents. This would be an unusual but not impossible scenario; for example, someone who is severely disabled might need enormous sums just for even basic support.

BAPCPA Miscellany

- Plan-to-plan transfer does not cause loss of exemption [11 USC § 522(b)(4)(C)] provides that “a direct transfer of retirement funds” under IRC § 401(a)(31) (the “direct rollover” provision of the Code) from one of the types of plans listed in USC § 522(b)(3)(C) “shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer;”
- Since in an IRC § 401(a)(31) direct rollover, money goes directly from one tax-exempt retirement plan into another, why is it necessary to specify that the direct transfer does not cause loss of the exemption? Perhaps Congress anticipated some clever creditors’ arguments that we have not thought of; or perhaps Congress is saying this type of transfer is to be considered a rollover contribution for purposes of the IRA limitation;
- Eligible rollover distributions can also be exempt. What good does it do to have an exemption for retirement plan benefits if creditors can seize the funds the minute they are distributed out of the plan? Congress addresses that problem by (apparently) allowing certain funds distributed from certain plans to retain their exempt status even after the distribution. Specifically, it appears that any “eligible rollover distribution” from a qualified plan CONTINUES to be exempt, regardless of whether it is actually rolled over;
- Eligible rollover distributions from the other types of protected plans apparently continue to be protected only if they are actually rolled over to another protected plan within 60 days. [11 USC § 522(b)(4)(D), added by § 224(a) of BAPCPA.]
- For qualified plans: “Any distribution that qualifies as an eligible rollover distribution within the meaning of IRC § 402(c) “shall not cease to qualify” for the exemption “by reason of such distribution;”
- An “eligible rollover distribution” is any distribution from a QRP other than a required minimum distribution (RMD), hardship distribution, or distribution that is part of a series of substantially equal periodic payments (SOSEPP) over the life or life expectancy of the employee (or of the employee and his beneficiary) or for a period of 10 years or more [IRC § 402(c)(4).];
- Similarly, any amount distributed from one of the listed exempt tax-qualified plans [IRC § 401, § 403, § 408, etc.] that is lawfully rolled over to another such
plan within 60 days “shall not cease to qualify for exemption…by reason of such distribution;” and

- Regardless of the type of plan, however, required minimum distributions (RMD)s, hardship distributions, and SOSEPP distributions LOSE their exempt status once they come out of the protected retirement plan.

**States Most Impacted**

The states which will likely be most affected by the ruling are Alaska, Arkansas, Connecticut, Hawaii, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, Pennsylvania, Rhode Island, South Dakota, Texas, Vermont, Washington and Wisconsin.

However, other states which “opted out” under the Federal Bankruptcy Law to set up their own protections for people who file Bankruptcy Petitions may also be impacted.

**Creditor Protection of Inherited IRAs**

Now the $64 million dollar question: Do beneficiaries of an inherited IRA have the same creditor protection afforded to them as the original IRA owner? The answer: It depends on where the beneficiary lives. The statutes and court interpretations vary from state to state. The law governing the protection of inherited IRAs from creditors is uncertain at best.

Below is a list of several bankruptcy court cases where the bankruptcy courts ruled that the inherited IRA does not have creditor protection and could be attached by creditors:

- Alabama *In re Navarre*, 332 B.R. 24 (M.D. Ala. 2004);
- California *In re Greenfield*, 289 B.R. 146 (S.D. Calif. 2003);
- Florida *In re Robertson*, 16 So.3d 936 (Florida 2009);
- Illinois *In re Taylor*, 2006 WL 1275400 (Bkrtcy C.D. Ill. 2006);
- Oklahoma *In re Sims*, 241 B.R. 467 (N.D. Okla. 1999);
- Texas *In re Jarboe*, 2007 WL 987314 (Bkrtcy S.D. Tex. 2007);
- Wisconsin *In re Kirchen*, 344 B.R. 908 (E.D. Wisc. 2006); and

To add to the confusion, bankruptcy courts in several other states have ruled to protect inherited IRAs. Here are several other Court cases that decided that the Inherited IRA is protected from creditors:

- *In re Chilton*, United States Bankruptcy Court, E.D. Texas Case No 08-43414, March 5, 2010, in which the bankruptcy court denied an exemption for the inherited IRA of the bankrupt. However, the US District Court has now reversed the Chilton bankruptcy court ruling in Chilton v Moser, 107 AFTR 2d ¶ 2011-594 (DC TX 3/16/2011), holding that an inherited IRA is an exempt asset;
• The Eight Circuit Bankruptcy Appellate Panel in *In re Nessa*, Case No. 10-6009 (Bkrtcy Appellate Panel CA 8, April 9, 2010), AFTR 2010-1825, determined that an inherited IRA qualifies for exemption under USC § 522(d)(12) of the Bankruptcy Code;

• *In re Kutcha*, 434 B.R. 837 (Case No. 09-15538, ND. Ohio, April 16, 2010) the bankruptcy court first reviewed Ohio bankruptcy exemptions, since Ohio is an opt-out state (Ohio exemptions, not federal exemptions, applied in this bankruptcy estate). The court found an inherited IRA is not exempt under Ohio law. The court went on to rule that, in an opt out state when state exemptions apply, the federal exemption for retirement funds found in USC § 522(b)(3)(C) applied to provide the same protection otherwise applicable under USC § 522(d)(12). The court then ruled that an inherited IRA is exempt from creditors in bankruptcy;

• *In re Tabor*, 433 B.R. 469 (M.D. Pennsylvania, Case No. 1:09-bk-05277MDF, June 8, 2010), where Pennsylvania is an opt out state so that the state law exemptions applied, the bankruptcy court declined to rule on whether the inherited IRA was exempt under Pennsylvania law. Instead, the bankruptcy court ruled that the inherited IRA was exempt under USC § 522(b)(3)(C) of the Bankruptcy Code;

• *In re Wellhammer*, 2010 WL 3431465 (S.D. California, Case No. 09-15148-LT7, August 30, 2010), an unpublished decision, a California debtor (California is an opt out state) claimed an exemption under USC § 522(b)(3)(C). While the court found the issue was a close question, the court ruled that the inherited IRA contained “retirement funds”, albeit those of a relative of the debtor. The court ruled that the inherited IRA was exempt under USC § 522(b)(3)(C);

• *In re Thiem*, 107 AFTR 2d 2011-529 (AZ January 19, 2011), (Arizona is an opt out state), where the Arizona exemption state specifically included the interest of a beneficiary in an IRA among the state exemptions, after noting that “neither case law nor the legislative history (of the Federal Bankruptcy Code) reveal any useful information pertaining to the application of this statute to an inherited IRA,” the court concluded that the requirement that the funds be “retirement funds” did not require that the funds be the retirement funds of the debtor. The court ruled that the inherited IRA was exempt;

• *In re Mathusa*, 2011 WL 1134680 (Bkrtcy M.D. Fla.) the IRA Marilyn Mathusa inherited from her mother was an exempt asset under court likewise concluded that the IRA asset under USC § 522(b)(3)(C) of the Bankruptcy Code (Florida is an opt out state);

• *In re Johnson*, 452 B.R. 804 (Bkrtcy. W.D. Washington May 4, 2011), the debtor elected the federal exemption. After noting that the clear trend was to allow exemptions for inherited IRAs, the court agreed with the analysis of the prior cases and ruled that the inherited IRA was exempt under USC § 522(d)(12);

• *In re Stephenson*, U.S. District Court, E.D. Mich., No.4:11-cv-10848-MAG- MAR, December 12, 2011, the bankruptcy Court in this case agreed with the Trustee that the inherited IRA was not exempt from the bankrupt’s estate, the District Court did not. In this case Janet Stephenson had inherited an IRA from her mother two years before filing for bankruptcy. The Stephenson’s claimed an exemption for the IRA under the Federal Bankruptcy Exemption in USC §
522(d)(12), and the Trustee objected. In reviewing this case, the District Court first reiterated the two-prong test used in the other cases mentioned above, whether the funds were “retirement funds” and whether the funds are exempt from taxation. After reviewing the case law discussed above, the Court found that the Chilton case, the earliest of this line of cases, was “incredibly well-reasoned” and commented that the Clark case was the only case to the contrary. The court concluded that there was nothing in the Bankruptcy Code that would require the funds to be the debtor’s retirement funds; the funds simply had to be funds saved by someone for retirement. Accordingly, the court rejected the position taken by the court in the Clark case, and reversed the holding of the Bankruptcy Court, ruling that inherited IRAs are exempt under USC § 522(d)(12) of the 2005 Bankruptcy Code; and

- **In re Heidi Hefron-Clark**, decided on April 23, 2013, the U.S. Court of Appeals for the Seventh Circuit recently halted a strong trend in the courts to protect inherited IRAs in bankruptcy. The court reasoned that the inherited IRA did not represent a “retirement fund” and were not exempt from creditors.

With all this confusion it was only time before everything moved its way up to the Supreme Court.

**Clark v. Rameker**

On June 12, 2014, Justice Sonia Sotomayor delivered the opinion of a unanimous Supreme Court in the case of *Clark v. Rameker* (714 F.3d 559 (7th Cir. 2013) to answer the question of whether assets held under an inherited IRA (and likely other types of qualified retirement plans, such as 401(k)s) would qualify as “retirement funds” under the applicable bankruptcy exemption (discussed above). The Court held that assets held under an IRA inherited by a non-spouse beneficiary after the death of the IRA owner are not “retirement funds,” and therefore are not protected under federal bankruptcy law.

**Facts**

In 2001, Ruth Heffron died and left an IRA worth about $450,000 to her daughter Heidi Heffron-Clark, a resident of Wisconsin. Heidi elected to take monthly distributions from the IRA as her required minimum distributions. In 2010, Heidi and her husband, Brandon C. Clark, filed for bankruptcy under Chapter 7 of the Bankruptcy Code, exempting the IRA (then worth around $300,000) under 11 USC Section 522(b)(3)(C). The Clarks’ creditors argued that the inherited IRA did not fall within the meaning of “retirement funds” and thus was not exempt from the bankruptcy estate.

The bankruptcy court ruled in favor of the creditors, stating that inherited IRAs are not “retirement funds, because the funds are not set aside for retirement needs, nor are they distributed upon retirement.” The decision was then appealed to a federal district court. The district court reversed the decision of the bankruptcy court, holding that inherited IRAs do qualify as retirement funds and are exempt from the bankruptcy estate under the
USC § 522(b)(3)(C) exemption. The decision was appealed yet again to the Seventh Circuit, which agreed with the bankruptcy court that inherited IRAs do not qualify for the USC § 522(b)(3)(C) exemption. This ruling was in conflict with *In re Chilton*, 674 F.3d 486 (5th Cir. 2012) which held that inherited IRAs were exempt because “the defining characteristic of ‘retirement funds’ is the purpose they are ‘set apart’ for, not what happens after they are ‘set apart’.”

The Supreme Court agreed to hear the case in order to resolve the split in the circuit courts.

The Court found that the language of Title 11 USC § 522(b)(3)(C), which describes protected assets to include “retirement funds” that are “exempt from taxation” under IRC § 401, § 403, § 408, § 408A, § 414, § 457, and § 501(a), means that the account has to be characterized as a retirement vehicle for an employee or the contributor and compliant with the rules described in the above referenced Sections.

Further, the Court held that assets held under an IRA inherited by a non-spouse beneficiary are not “retirement funds” that are protected under USC § 522(b)(3)(C) because it was Congress’s intent to “help the debtor obtain a fresh start,” and not to provide a windfall to those who would simply inherit by receiving a “free pass.”

Specifically, the Court noted that:

“...allowing that kind of exemption would convert the Bankruptcy Code’s purposes of preserving debtors’ ability to meet their basic needs and ensuring that they have a fresh start, into a ‘free pass’.”

The Court went on to note that “inherited IRAs do not operate like ordinary IRAs” because unlike ordinary IRAs or Roth IRAs, the owner of an inherited IRA “not only may, but must withdraw its funds... within 5 years of the original owner’s death or take minimum distributions on an annual basis... and “unlike a traditional or Roth IRA, the owner of an inherited IRA may never make contributions to the account.”

Accordingly, the debtors were not entitled to have their inherited IRA excluded from the bankruptcy estate as an exempt asset, and the assets held under such IRA were subject to the claims of their creditors.

**Three Characteristics Referenced by the Court**

The Three Characteristics Referenced by the Court: Will They Be Universally Applied?

In reaching its holding, the Court described three characteristics of inherited IRAs that distinguish such accounts from tax advantaged retirement accounts that are considered as held for retirement and are therefore afforded protections from creditor claims under the Bankruptcy Code. While the Court viewed these characteristics in the context of an
inherited IRA, other types of accounts (which universally may be thought as creditor exempt) might exhibit these characteristics, and there will doubtlessly be years of litigation and uncertainty as a result of this opinion.

- The first characteristic is that a holder of an inherited IRA is not able to invest additional monies into the IRA. It is noteworthy that there are frozen pension plans (that are exempt from taxation under IRC § 401, § 403, § 408, § 408A, § 414, § 457, or § 501(a)) into which contributions cannot be made, but which are clearly held for retirement;

- The second characteristic is that a holder of an inherited IRA is required to withdraw monies from such account upon at least an annual (or more frequent) basis in the form of required minimum distributions. In certain situations, an owner of or participant in a retirement account is required to take withdrawals from the account, such as after the holder reaches age 59 ½ or has elected to take distributions from the account over a series of substantially equal periodic payments made at least annually; and

- The third and final characteristic described by the Court is that a holder of an inherited IRA is permitted to withdraw the entire balance of the account at any time, and for any reason, without penalty. Again, an owner of or participant in a retirement account who has attained age 59 ½ is entitled to withdraw as much of the assets from the retirement account as he or she desires, without penalty. Additionally, an owner of or participant in a retirement account may be entitled to withdraw amounts as he or she determines from his or her retirement account without penalty, if such individual meets one or more of the exceptions to the 10% penalty tax for early withdrawals from retirement accounts described in IRC § 72(t)(2) (such as distributions attributable to the owner/participant being disabled or made for certain medical expenses).

The Court did not provide very much discussion with respect to these characteristics, or how they would apply to retirement accounts that are protected from creditors in bankruptcy. In fact, the only discussion in the opinion of the first characteristic is as follows:

“Inherited IRAs are thus unlike traditional and Roth IRAs, both of which are ‘quintessential retirement funds.’ For where inherited IRAs categorically prohibit contributions, the entire purpose of traditional and Roth IRAs is to provide tax incentives for account holders to contribute regularly and over time to their retirement savings.”

The Court’s only discussion on the second characteristic was to the effect that the IRC requires the withdrawal of all of the funds in an IRA within five years of the death of the IRA owner, or over the life expectancy of the IRA beneficiary through yearly distributions from the IRA. The Court’s sole analysis of this requirement as it relates to inherited IRAs is:
“...that the tax rules governing inherited IRAs routinely lead to their diminution over time, regardless of their holders’ proximity to retirement, is hardly a feature one would expect of an account set aside for retirement.”

Further, the only discussion on the third characteristic indicates that the 10% penalty tax that applies to the withdrawal of funds from a traditional or Roth IRA before the owner or participant reaches the age of 59 ½ encourages individuals to leave the funds untouched until they reach retirement age. Inherited IRAs have no such provisions, and according to the Court:

“...constitute a pot of money that can be freely used for current consumption, not funds objectively set aside for one’s retirement.”

The Court also noted that although the 10% penalty tax does not apply to withdrawals of contributions from a Roth IRA because such contributions are made with after-tax income (i.e., they were already subject to income taxes), withdrawals of any gains or investment income from a Roth IRA are in fact subject to the 10% penalty tax absent the application of a limited exception. This is different from an inherited IRA where no withdrawals of assets are subject to the 10% penalty tax.

It will therefore remain to be seen how and when these three characteristics might be universally applied to retirement accounts to determine what other types of accounts will qualify for protection under the Bankruptcy Code.

**Planning After the Supreme Court Ruling**

Notwithstanding the negative result for the debtor, this Supreme Court decision may do more good than harm by propelling estate planning practitioners and advisors to encourage clients to leave retirement accounts and IRAs paid to a trust, more specifically an Accumulation Trust. Another consequence of this decision will be that many state legislatures will undoubtedly consider the question of providing state law exemption for inherited IRAs so that the bankruptcy will protect these for state citizens who file bankruptcy.

As of the date of this ruling the following states have passed legislation to specifically protect inherited IRAs. They are:

- Alaska [Stat § 33-38.017(a)(3)];
- Arizona [Rev. Stat. § 33-1126(B)];
- Florida [F.S. § 222.21];
- Idaho [Code § 11-604A];
- North Carolina [Stat. § 1C-1601(a)(9)];
- Ohio [R.C. § 2329.66(A)(10)(e)]; and
- Texas [Prop Code § 42.0021].
Florida Update

In Robertson v. Deeb [16 So.3d 936 Florida 2009], the Florida District Court of Appeals held that Florida Statute (F.S) § 222.21(2)(a)] didn’t extend to inherited IRAs. The case involved Richard Robertson, who was the beneficiary of his father’s $75,000 IRA. When Richard’s father died, the IRA custodian gave Richard two options regarding the IRA.

- The first was to transfer the IRA to an inherited IRA, requiring Richard to take minimum distributions based on his life expectancy and allowing him to withdraw additional amounts without penalty; and
- The second was to keep the IRA in his father’s account and take distributions over five years.

Richard chose to transfer the IRA to an inherited IRA. Subsequently, an $188,000 judgment was entered against Richard and the creditor served a writ of garnishment on the custodian of the inherited IRA. Richard filed a claim of exemption, arguing that the inherited IRA was exempt from garnishment under F.S. § 222.21(2)(a).

Affirming the lower court, the appeals court concluded that F.S. § 222.21(2)(a) doesn’t apply to inherited IRAs because “the plain language of that section references only the original ‘fund or account’ and the tax consequences of inherited IRAs render them completely separate funds or accounts.” According to the court, an inherited IRA is a separate account created when the original account passes to a beneficiary upon the participant’s death and when an IRA becomes an inherited IRA, the account’s tax-exempt status changes, since the beneficiary is required to take distributions and may not roll over the inherited IRA. In contrast, the original IRA owner isn’t required to take distributions (and in fact is penalized for early withdrawal of the funds) and may roll over the IRA without penalty.

In May 2011, the Florida Legislators, both the House and Senate, unanimously passed House Bill 469, amending the code to provide full protection of inherited IRAs under F.S. § 222.21. The bill was signed into law by Governor Rick Scott. HB 469 amends F.S. § 222.21 by inserting the following underlined language:

“...any interest in any fund or account that is exempt from claims of creditors of the owner, beneficiary or participant...does not cease to be exempt after the owner’s death by reason of a direct transfer or eligible rollover...including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in s. 408(d)(3) of the Internal Revenue Code of 1986, as amended.”

In addition, HB 469 adds F.S. § 222.21(c), which provides that “this paragraph is intended to clarify existing law, is remedial in nature, and shall have retroactive application to all inherited individual retirement accounts without regard to the date an account was created.”
This amendment to F.S. § 222.21 has widespread importance to not only current beneficiaries of inherited IRAs who reside in Florida but also nonresidents who are considering whether or not to name a Florida resident as a designated beneficiary of a retirement plan. It is important to remember that the governing law of the designated beneficiary’s domicile will control whether the assets of an inherited IRA are protected from the claims of the designated beneficiary’s creditors, not the governing law of the domicile of the retirement plan owner.

Now that HB 469 has been enacted, an inherited IRA of a Florida resident debtor is protected in both state court and bankruptcy court. However, practitioners may still want to explore the use of a conduit trust or accumulation trust as the designated beneficiary of a retirement plan instead of naming a Florida resident in order to guard against a designated beneficiary relocating to an unfavorable jurisdiction or future changes in the state law.

Ohio

On March 27, 2013, Ohio legislators and the governor signed into law, Ohio Revised Code (ORC) § 2329.66(A)(10)(e) specifically exempting inherited IRAs from creditor claims in Ohio.

North Carolina

In June 2013, North Carolina’s Governor signed Senate Bill 279 into law, which made changes to statutes related to estates, trusts, and guardianships. One change provides additional creditor protection on retirement accounts in North Carolina. The updated law states:

“Any money or other assets or any interest in any such plan remains exempt after an individual’s death if held by one or more subsequent beneficiaries by reason of a direct transfer or eligible rollover that is excluded from gross income under the Internal Revenue Code including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in section 408(d)(3) of the Internal Revenue Code.”

This means retirement accounts in North Carolina are free from the enforcement of creditor claims, both before and after the original account holder’s death. The updated creditor exemptions in the North Carolina statutes address:

- Individual retirement accounts;
- Roth retirement accounts;
- Individual retirement annuities; and
- Accounts established as part of a trust.
Although retirement accounts (if eligible under the terms above) are exempt from being drawn to pay a decedent’s outstanding debts, executors must use other assets to pay down all debts prior to distributing estate assets. Property that is not exempt from creditor claims, such as bank accounts or certain real property, must be tapped to pay debts.

**Medicaid Planning and IRAs**

In some states, IRAs and other retirement accounts are given preferential treatment when applying for government-financed health care such as Medicaid. This can be important since long-term care in a nursing home can cost in excess of $10,000-$12,000 per month in certain parts of the country.

For single individuals in certain states, an IRA or other retirement accounts in “pay-out status” will not be counted as an asset with respect to that individual’s eligibility for nursing home benefits under Medicaid. An individual must be in receipt of periodic distributions from the IRA in order for it to be considered in “pay-out” status.

For individuals who have reached their required beginning date (RBD), the receipt of their required minimum distribution (RMDs) will mean that the IRA is in “pay-out” status. Those who have not yet reached age 70½, are able to utilize a specific Medicaid life expectancy table for this purpose since there are no IRS RMD tables for those under age 70½. Although the Medicaid tables are not based on a joint life expectancy as are the IRS tables, they still yield a better result than liquidating the IRA in most cases.
Chapter 11
Review Questions

1. Which of the following Supreme Court decisions ruled that ERISA plans will NOT be included in the bankruptcy estate?

( ) A. Rousey v. Jacoway
( ) B. Patterson v. Shumate
( ) C. Lampkin v. Golden
( ) D. Reid v. Commissioner

2. Under federal bankruptcy laws, prior to the enactment of BAPCPA, which of the following types of qualified retirement plans was NOT protected from creditor claims?

( ) A. IRC § 401(k)
( ) B. Profit sharing plans
( ) C. Defined benefit plans
( ) D. Traditional IRAs

3. What is another name for a “restriction on transfer”?

( ) A. Spendthrift clause
( ) B. Savings clause
( ) C. Credit clause
( ) D. None of the above

4. True or False. Employer-sponsored qualified plans, like 401(k) plans, for example, are fully exempt because they are shielded from creditors by ERISA.

( ) A. True
( ) B. False

5. For 2017, what is the aggregate value (indexed for inflation) for a Traditional IRA exempt from the bankruptcy estate under BAPCPA?

( ) A. $5,490,000
( ) B. $2,500,000
( ) C. $1,283,025
( ) D. $3,500,000
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CHAPTER 12

ESTATE PLANNING WITH RETIREMENT ASSETS

Overview

When we begin to discuss estate planning with our clients, one of the first things that we usually do is to take an inventory of our client’s current assets and then we project into the future and try to estimate the assets they will have when they die. If you take a moment and think about this right now, aside from one’s residence, the most valuable asset they may currently own (and that they will own at the time of death) is most likely to be their retirement savings (IRAs, 401(k) accounts, and other employer-sponsored retirement plans). And, without proper planning, those retirement assets can be a ticking time bomb that requires the payment of significant taxes by the beneficiaries. Looking at things from this perspective really drives home the importance of estate planning in connection with saving for retirement.

This chapter will review the basics of the federal estate tax, the federal tax law changes enacted under the American Taxpayers Relief Act (ATRA) of 2012, and how IRAs are calculated as part of the estate. The chapter will also review the rules pertaining to Income Respect to a Decedent (IRD) property.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Define the federal estate tax;
- Calculate the federal estate tax;
- Determine what constitutes the gross estate;
- Outline how retirement plans are subject to the federal estate tax;
- Explain income respect of a decedent (IRD) property; and
- Offer the benefits of the IRD deduction.

The Federal Estate Tax

The federal estate tax is a tax the U.S. government imposes on an individual’s right to transfer assets or property to other people at the time of the individual’s death. That’s why it is referred to as the death tax.
The American Taxpayer Relief Act of 2012

On January 1, 2013, the House of Representatives voted in favor of the American Taxpayer Relief Act (ATRA) of 2012 (H.R. 8) and President Obama signed it into law.

The Act permanently extends a number of tax provisions that makes significant changes to the estate, gift, and generation skipping transfer taxes. Table 12.1 displays the changes to the tax rate and exemptions.

Table 12.1
ATRA of 2012
FET, Gift and GST Exemptions and Tax Rates, 2016-2017

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate Tax</td>
<td>$5,450,000 Exemption* Max 40% Tax rate</td>
<td>$5,490,000 Exemption* Max 40% Tax rate</td>
</tr>
<tr>
<td>Gift Tax</td>
<td>$5,450,000 Exemption* Max 40% Tax Rate</td>
<td>$5,490,000 Exemption* Max 40% Tax Rate</td>
</tr>
<tr>
<td>GST Tax</td>
<td>$5,450,000 Exemption* (indexed from 2004) Max 40% Tax Rate</td>
<td>$5,490,000 Exemption* (indexed from 2004) Max 40% Tax Rate</td>
</tr>
</tbody>
</table>

Note: ATRA of 2012 made the tax rates and exemptions permanent in the Code (indexed for inflation in later years in increments of $10,000.

IRAs and Estate Planning

A Traditional IRA, Roth IRA, SEP IRA, or SIMPLE IRA will generally be fully includable in the estate of the IRA participant. A decedent’s estate includes the value of an annuity or other payment receivable by reason of surviving the decedent where the decedent held certain interests in the property while alive [IRC § 2036]. The amount includable is proportionate to the part of the purchase price contributed by the individual. Any contribution by the employer of the deceased individual to the Traditional IRA, Roth IRA, SEP IRA, or SIMPLE IRA is treated as made by the employee for this purpose [IRC § 2036(b)]. Thus the IRA participant will generally have contributed 100 percent of the contributions to the Traditional IRA, Roth IRA, SEP IRA, or SIMPLE IRA and the full value of the IRA will be included in the participant’s estate.

If upon the IRA participant’s death, the Traditional IRA, Roth IRA, SEP IRA, or SIMPLE IRA passes to the spouse of the IRA participant, the transfer will generally qualify for the marital deduction [IRC § 2056(a)]. If the transfer to the surviving spouse qualifies for the marital deduction, any amount still left in the IRA at the surviving spouse’s death will be includable in the surviving spouse’s estate.
QTIP Qualifications

Distributions from an IRA to a testamentary QTIP (Qualified Terminal Interest Property) trust will qualify for the marital deduction if certain conditions are met. QTIP status is defined as property that passes from the decedent, in which the surviving spouse has a qualifying income interest for life. Furthermore, no person may have the power to appoint any part of the property to any person other than the surviving spouse during that spouse’s life [IRC § 2056(b)(7)(B)(ii)]. In Rev. Rul. 89-89, 1989-2, C.B. 231, the IRS held that distributions from an IRA to a QTIP trust qualified for the marital deduction under the following conditions:

- The decedent must elect an IRA distribution option requiring that the principal balance be distributed in annual installments to a QTIP testamentary trust and the income earned on the undistributed balance of the IRA is to be paid annually to the trust; and
- The trust must pay out as current income to the decedent’s spouse for life, both the income earned on the undistributed balance of the IRA (which it receives from the IRA) and the income earned by the trust on the distributed portion of the IRA.

Note: The value of an IRA includable in the gross estate is not discounted for income tax payable by the beneficiary or for lack of marketability. Also an IRA (and other types of qualified retirement plans) do not receive a stepped up cost basis at the participant’s death. However, any federal estate taxes paid that are attributable to an IRA (and/or qualified retirement plan) are deductible for income tax purposes [IRC § 691(c)].

Income In Respect of a Decedent (IRD)

Understanding the tax deductibility of income in respect of a decedent (IRD) is gaining significance as the baby boomer generation reaches retirement. Once thought to be relatively obscure, IRD deductions are becoming more common. Big-ticket IRD items such as distributions from IRAs, 401(k)s, 403(b)s and other tax-sheltered retirement plans such as annuities of affluent baby boomers have been growing in past decades and will be worth millions when owners bequeath them to estate beneficiaries.

Distributions from these plans constitute gross income to the beneficiary and could be subject to marginal federal income tax rates as high as 39.6%. Plan balances also are subject to federal estate tax rates as high as 40% (in 2017)—a double whammy. Together, these taxes can severely reduce the size of a beneficiary’s inheritance.

Proper handling of IRD tax issues, therefore, is critical to sheltering retirement plan accumulations from tax. Current federal tax provisions allow an IRD deduction on the beneficiary’s income tax return for federal estate taxes attributable to IRD taxed on the deceased’s federal estate tax return. The following years will be critical, as many individuals will become beneficiaries of estates that include IRD, elevating the importance of the IRC § 691(c) deduction.
Historical Development of IRD

Prior to 1934 IRD items escaped federal income taxation. They were viewed as part of the gross estate subject to estate tax, not as income to the estate or its beneficiaries. This treatment allowed large amounts of income to go untaxed. In 1934 Congress put a stop to this by requiring all income accrued to a decedent at death to be reported as income on the decedent’s final income tax return. This resulted in the income’s being taxed even though the deceased had not yet received it. In essence the provisions treated cash-basis taxpayers as accrual-basis taxpayers and clearly ignored a basic tenet of taxation: the wherewithal-to-pay concept.

A fundamental principle of taxation, this concept rests on the belief that one should be taxed on a transaction when he or she has the means to pay the tax. Under the 1934 provisions, a decedent’s death accelerated IRD income recognition from the period it originally was scheduled to be received to the period of the decedent’s final return. Given that actual receipt of the income might have been scheduled to occur several years later, it often became difficult for taxpayers to pay tax on the accelerated income.

Accelerating all income recognition to the decedent’s final tax return resulted in a “bunching” of income in a single period. The result? Both the accelerated income and all other taxable income on the decedent’s final return potentially became subject to higher tax rates in the progressive income tax system.

This deduction is allowed to the beneficiary of any IRD that caused an increase in the estate tax of the decedent. The deduction can reduce the added income tax the beneficiary would bear as a result of including the IRD on its return. Even though this is conceptually simple, taking the federal estate tax deduction on IRD is often erroneously calculated or missed entirely. Increased knowledge of what constitutes IRD and how and when the deduction is taken, and recognition of why it is a continued problem, can result in more-accurate reporting and reduced taxes.

IRD Defined

In order to prevent the bunching of all income received after a decedent’s death on the final income tax return, Congress enacted IRC § 691, which essentially provides for taxing the beneficiary on the postmortem income as it is received. While there is no universal definition of IRD found in the IRC, Treas. Reg. § 1.691(a-b) provides a general guideline that IRD includes “those amounts to which a decedent was entitled as gross income but which were not properly includable in computing taxable income for the taxable year ending with the date of his death.” What constitutes IRD can vary depending on the type of income received, the method of accounting used by the decedent, and the date the income is actually received.
Tax issues arise when the recipient of the IRD is subject to the taxation on this income. According to IRC § 691, the following parties may be subject to IRD from the following:

- The estate of the decedent, if the right to receive the income is acquired by the decedent’s estate from the decedent;
- The person who acquires the right to receive the income by way of the decedent’s death, if the right to the income is not acquired by the decedent’s estate from the decedent; and
- The person who acquires the right to receive the income by bequest, devise, or inheritance, if the right to the income is received through a distribution from the decedent’s estate.

No matter who the beneficiary is, the income, when received, will be taxed to the beneficiary as it would have been taxed to the decedent. Whenever a taxpayer dies, the beneficiary of the property generally receives a step-up (or step-down) in basis in the property equal to the fair market value of the property on the decedent’s date of death (IRC § 1014). Any increase in basis will help offset any gross sale proceeds. As an exception, however, IRD denied this IRC § 1014 basis to prevent realized but unrecognized income from evading its predetermined recognition by hiding behind a taxpayer’s death. IRD does not receive a step-up in basis, because the income has not been taxed on the decedent’s individual income tax return, although it is includable as an asset on the decedent’s estate tax return.

**Example:** Barbara, a decedent, was owed $5,000 in wages upon her death. The beneficiary of these wages, Bob, will have the same basis in the income as Barbara did, in this case $0. Bob will recognize the same amount of income as would have been recognized by Barbara; in this case all $5,000.

Almost all IRD is included in the gross estate of a decedent, much like all other decedent property, but it is also included in the beneficiary’s income tax return when received, to ensure proper taxation of the actual recipient. The IRD beneficiary’s deduction comes in the form of a miscellaneous itemized deduction not subject to the 2% of AGI floor equal to the estate tax attributable to the net IRD [IRC § 67(b)(8)].

**IRD Property**

To determine whether an item of income is IRD, you must first ascertain whether the income has been included on the decedent’s individual income tax return. If it has not been subjected to income tax, one must determine how it would have been taxed to the decedent; a decedent’s income reported by the beneficiary retains the same character it would have had in the hands of the decedent [IRC § 691(a)(3); Treas. Reg. § 1.691(a)-3]. The other consideration is the accounting method used by the decedent. In general, beneficiaries of cash-basis decedents must claim all IRD when actually received unless the income was constructively received on the decedent’s date of death. On the other hand, the beneficiaries of an accrual-basis decedent must claim only qualified death benefits and deferred compensation owed to the decedent as IRD; other income, such as
interest and wages accrued on decedent’s date of death, would be reported on an accrual basis on the decedent’s final Form 1040.

Specific examples of compensation owed to a beneficiary because of a decedent’s death and treatment are as follows:

- **Wages and salaries.** Salary or wages earned by a cash-basis decedent but unpaid as of his/her date of death constitute IRD. Bonuses for services rendered payable to a cash-basis decedent upon death are considered IRD if there was “substantial certainty” the bonus would have been awarded, unless paid directly to the recipient and thus considered a gift [*O’Daniel’s Estate v. Comm.*, 37 AFTR 1249 (1948)]. Fringe benefits are considered IRD unless they would not have been included in the decedent’s gross income, such as payments for permanent loss or disfigurement. Post death payments to a third party are classified as IRD even though the decedent was not entitled to them [*Estate of DiMarco v. Comm.*, 87 T.C. 653 (1986)];

- **Self-employment income.** Outstanding income owed to a self-employed decedent (accounts receivable) is considered IRD but is not subject to self-employment tax;

- **Interest.** IRD includes interest accrued but not paid to a cash-basis decedent. Accrual-basis decedents do not consider accrued but unpaid interest as IRD, but instead claim the revenue on their final 1040;

- **Dividends.** Decedents must be entitled to the dividend at death for the dividend to be considered IRD. A decedent would be entitled if the record date of the dividend precedes the decedent’s date of death. If the record date is after the date of death, dividends are considered ordinary income to the decedent’s beneficiary.

- **Rents and royalties.** Rents accrued on a day-to-day basis since the last rental payment that remain unpaid on a cash basis at the decedent’s date of death represent IRD. Unpaid royalties attributable to pre-death time periods qualify for IRD treatment (IRS Rev. Rul. 60-227, 1960-1CB262);

- **Sales proceeds.** To be considered IRD, sales proceeds must meet the following requirements [Treas. Reg. § 1.691(a)-2(b)]:
  - The decedent entered into the contract for sale of the property at hand;
  - The property must have been in a deliverable state upon the decedent’s death (executor has only a passive or administrative role in the sale);
  - No material contingencies would have disrupted the sale; and
  - The decedent would have constructively or actually received the sale proceeds if he/she had lived (the sale could have been considered a receivable).

- **Deferred compensation.** Deferred compensation includes payments received under such plans [e.g., 401(k) and Traditional IRAs], whether or not the decedent was eligible to receive the payments upon death (IRC §§ 2031 and 2039). Deferred compensation can either be monies payable to an employee [defined for IRD purposes as amounts that an employee agrees can be deducted from his earnings for payment at a later date; amounts that are tax deferred; and amounts for which the postponed payments have not been paid upon a decedent’s death, as per Treas. Reg. § 1.691(a)-2(b) or monies not payable to an employee, as well as
monies payable to an employee’s beneficiaries upon the employee’s death. To be excluded from IRD, the beneficiary must prove that the compensation would not have been included in the decedent’s gross income when received. For example, Roth IRA distributions would not have been taxable to the decedent and thus are not taxable to the beneficiary, because original contributions to the plan were not tax deductible. In addition, retirement distributions that exceed the IRA participant’s taxable IRA balance (the value at date of death, including appreciation and accrued income less non-deductible contributions) are not considered IRD (Revenue Ruling 92-47, 1992-1CB198).

**Example:** John receives $500 per month in distributions from a Traditional IRA plan. John dies after receiving 10 distributions, while the value of the account is $7,500, including unrealized appreciation and accrued income and less non-deductible contributions. John’s daughter, Sue, receives the right to the IRA balance upon John’s death, and must include IRD in her gross income in each year she receives a distribution.

- **Installment sale receipts.** The recipient of an installment obligation from a decedent would continue reporting the receipt of payments just as the decedent had. The IRD portion of an installment sale payment should equal the gross profit ratio multiplied by the annual payment, plus any accrued interest of a cash-basis decedent not yet received [IRC § 691(a)(4)].

**Example:** Dan sells a piece of real estate he owns for $200,000. The buyer promises to make 10 equal annual principal payments of $20,000 for the next 10 years. Dan’s adjusted basis in the property was $80,000 at the date of the sale. Therefore, the gross profit ratio of this sale was 60% \( \frac{($200,000 – $80,000)}{$200,000} \), and 60% of each annual payment is reported as a gain. Dan dies after receiving only two annual $20,000 payments. The installment obligation becomes an asset of Dan’s beneficiary, his estate; when it receives the third annual payment, it would consequently report $12,000 in IRD. This reporting will continue if the note is passed to a beneficiary. Any interest that was accrued and owed to Dan upon his death would also be considered IRD; any interest accruing after Dan’s date of death would be classified as ordinary income.

- **Partnerships.** Under IRC § 706, partnership income attributable to the period before the decedent’s death should be included in the partner’s final income tax return. All partnership income attributable to postmortem periods will be included in the income tax return of the successor (estate or beneficiary) of the deceased partner’s partnership interest. Thus, no IRD will be recognized by the successor no matter how much distribution from the partnership is received by a successor at a later date. In addition, IRD generally includes unrealized receivables of a cash-basis partnership upon the partner’s death that were later realized by the partnership [IRC § 751(c)].
**Example:** Nona, a 20% partner in calendar-year and cash-basis N Partnership, died on June 19. Nona’s successor (her estate) continued as the partner for the remainder of the year. N Partnership’s income for the period ended June 19 was $180,000, and unrealized receivables at Nona’s death were $10,000. Nona’s share of this income ($36,000) was reported on her final K-1 and subsequently on her final income tax return. N Partnership’s income for the remainder of the year was $210,000, and the unrealized receivables were collected and realized. Nona’s estate included its share of this income ($42,000) in its gross income reported on its first estate income tax return. At year-end, N Partnership distributed the entire year’s proportionate share of income and collections ($78,000 of income and $2,000 of post-death realized receivables) to Nona’s estate. Only $2,000 would be considered IRD, because the other portion of the distribution had already been reported in either Nona’s or the estate’s gross income.

- **S Corporations.** An individual inheriting S Corporation stock from a decedent must treat the decedents pro-rata share of any IRD items (accrued but unpaid income items) as IRD. S Corporation stock received by a beneficiary would receive an IRC § 1014 step-up in basis [Reg. IRC § 1.1367-1(j)]. The basis of S Corporation stock that is acquired from a decedent must be reduced by the value of the stock that is attributable to the IRD items of the decedent related to the S Corporation [IRC § 1367(b)(4)(B)].

**Example:** ABC Inc., an S Corporation, has 300 shares of stock outstanding. Paul owns 75 shares, which are worth $100,000 at his date of death. Also on this date, ABC’s accrued but not received income totaled $8,000. As a result, the beneficiary, Mary’s basis in the 75 shares received from Paul is stepped up to $100,000 (according to IRC § 1014), then reduced by $2,000 (Paul’s share of IRD items). In addition, Paul must report $2,000 of IRD on his income tax return.

**Deductions in Respect to a Decedent**

Regardless of accounting method, IRD is subject to income tax when a triggering event, generally the actual receipt of the income by the beneficiary, occurs. One way to initially reduce the tax to the beneficiary is by claiming a deduction in respect to decedent (DRD) to offset the revenue. The IRS allows any recipient of current or future IRD to deduct any properly allocable expenses against the income that was properly not claimed on the decedent’s final return [IRC § 691(b)]. Common DRD items include fiduciary fees, commissions paid to dispose of assets, and state income taxes. To be considered DRD, the expense must be paid by the beneficiary that actually acquires an interest in the property. DRD can be used to offset IRD on both the estate tax return and the beneficiary’s income tax return, just as IRD is taxed on both. DRD is treated similar to IRD in that it must be deducted in the same manner as the decedent would have taken the deduction.
Example: Bob inherits property from Pam upon her death. This property includes a parcel of real estate, and $5,000 in gross wages payable to Pam upon her death. During the current tax year, Bob collects the $5,000 in wages, less $1,000 in federal taxes and $500 in state taxes; he also pays $1,200 in property taxes on the real estate inherited. On Bob’s current-year income tax return, he must claim the $5,000 in wages as IRD and include it in his gross income. Bob may, however, deduct $500 of DRD for the state income taxes withheld from Pam’s final paycheck. Bob may also deduct $1,200 for the property taxes he paid, even though the real estate did not generate any IRD. These DRD items will be deducted in the same form as they would have been on Pam’s return.

Calculation of the Deduction

If an estate is subject to federal estate tax and the gross estate includes IRD, the beneficiary may claim all or part of the federal estate tax deduction on its income tax return [IRC § 691(c)]. The calculation of this deduction varies depending upon the number of IRD items and IRD recipients. No matter the intricacy of the computation, the goal remains the same:

- Calculate the estate tax that qualifies for the deduction; and
- Determine the IRD recipient’s portion of the deductible tax.

According to IRC § 691 (c) and Treasury Regulations § 1.691(c)-1, the federal estate tax deduction available to a beneficiary is calculated as follows:

- Establish the fair market value of all IRD items that are included in the gross estate. This value may not be what is ultimately collected by the beneficiary. Next, determine the net value of the IRD by reducing the above value by all related DRD, regardless of which beneficiary claims the deductions [IRC § 691(c)(2)(B)]; and
- Calculate the net estate tax on the gross estate, including the value of all IRD, and reduce it by any credits allowed. Exclude the net value of all IRD, and re-compute the net estate tax. The difference between the two calculations is the estate tax attributable to the inclusion of the net IRD and is the total deduction available to all IRD beneficiaries [IRC § 691(c)(2)(C)].

This deduction can be taken by the beneficiary as a miscellaneous itemized deduction not subject to the 2%-of-AGI limit. However, if more than one beneficiary receives IRD, or if IRD is received by a single person in more than one year, an additional computation must be made to determine each recipient’s annual deduction. The appropriate allocation of the deduction is calculated according to IRC § 691(c)(1)(A):

- Divide the individual gross value of any IRD being included in a beneficiary’s gross income by the total gross value of all IRD being included in the gross estate of the decedent. IRD should not be reduced by corresponding DRD when making this calculation; and
Multiply this fraction by the total federal estate tax deduction. The result will be the allocable federal estate tax deduction for each individual per year.

The following examples show the effect of situations that include multiple IRD recipients, including a surviving spouse, differences in the value of IRD and the actual IRD received, and IRD received over multiple years.

**Example: Multiple IRD recipients.** David died, leaving three children, Cory, Mark, and Joe. Upon David’s death, Cory and Mark each inherited $10,000 in IRD items and Joe inherited $5,000 in IRD items. Upon David’s death, Cory was liable for an item of DRD valued at $1,000, making the net IRD included in David’s gross estate $24,000. Assume that when the calculation shown in the Exhibit is done, the net estate tax attributable to the IRD items is $9,900. The calculation of each child’s portion of the $10,000 estate tax deduction is as follows: Cory’s and Mark’s Deduction = $3,960 [($9,900 x $10,000) ÷ $25,000]. Joe’s Deduction = $1,980 [($5,000 x $25,000) ÷ $9,900].

**Example: Multiple IRD recipients with a surviving spouse.** Assume Henry was survived by his wife, Cathy, and left IRD items of $10,000 to her, $10,000 to his son William, and $5,000 to his daughter Anne. Because the $10,000 left to Cathy qualifies for the marital deduction, it is excluded from the gross estate when calculating the total estate tax deduction. Assume the estate tax attributable to the inclusion of the $15,000 in IRD in Henry’s gross estate is $6,200. Cathy would then be entitled to an IRC section 691(c) deduction of $2,480 [($6,200 x $10,000) ÷ $25,000], even though her share of the IRD did not contribute to any estate tax, because of the marital deduction (Revenue Ruling 67-242, 1967-2CB277).

**Differences between the value of IRD and the actual amount received.** The value of an item of IRD upon the decedent’s death is used to determine the maximum federal estate tax deduction that an IRD recipient may claim, regardless of how much IRD is actually collected. If the amount of IRD actually collected is less than the determined value, the available IRC § 691(c) deduction must be recalculated. Assume that Steve inherits accrued but unpaid rent valued at $9,000 from Brad, a cash-basis taxpayer. The estate tax attributable to this rent, and thus the maximum IRC § 691(c) deduction, is $3,000. If, however, Steve is able to collect only a third of the rent ($3,000), he is entitled to only a third of the federal estate tax deduction ($1,000). Although Steve has lost a $2,000 deduction, he does not pay income tax on the uncollected rent of $6,000. An estate tax liability has already been calculated on the $9,000 value of the IRD, however, resulting in tax consequences.

**IRD received over multiple years.** Goldie is bequeathed an item of IRD valued at $10,000. The total IRC § 691(c) deduction related to this IRD is $3,000. Over the next 10 years, Goldie collects $1,000 per year related to this item of IRD. As a result, she is entitled to a federal estate tax deduction of $300 ($3,000 x $1,000/$10,000) per year to help offset the gross income included on her income tax return.
The examples above show that any person who includes IRD in gross income for the year is entitled to a portion of the IRC § 691(c) deduction regardless of whether IRD contributed to the estate tax and regardless of whether the amount of the IRD collected was less than its value. In addition, by not taking into account DRD items when computing each individual’s annual deduction, individuals that are not liable for the DRD do not receive any advantage from its payment by the liable beneficiary.

It is worth noting that each individual federal estate tax deduction can be claimed only in the same year in which the IRD is included in the recipient’s gross income. For example, a beneficiary cannot record IRD in its gross income in the year of the decedent’s death yet claim the IRC § 691(c) deduction in the following year, even if the estate was not settled until the second year. Likewise, if IRD is received by a beneficiary in a tax year following that of the decedent’s death, the federal estate tax deduction will be taken in the year the income is recognized, regardless of when the estate tax was actually paid.
1. What is the tax the U.S. government imposes on an individual’s right to transfer assets to other people at the time of the individual’s death?

( ) A. Income
( ) B. Gift tax
( ) C. Excise tax
( ) D. Estate tax

2. In what year was the American Taxpayers Relief Act signed into law?

( ) A. 2009
( ) B. 2013
( ) C. 2011
( ) D. 2010

3. True or False. Prior to 1934, IRD items escaped federal income taxation.

( ) A. True
( ) B. False

4. Which Section of the Internal Revenue Code (IRC) allows a deduction for income in respect of a decedent (IRD) property that is subject to both an estate tax and income tax?

( ) A. IRC § 5329
( ) B. IRC § 401(a)(9)
( ) C. IRC § 691(c)
( ) D. IRC § 72

5. A distribution from an IRD plan is gross income to the beneficiary and could be subject to marginal federal income tax rates as high as:

( ) A. 15%
( ) B. 39.6%.
( ) C. 28%
( ) D. None of the above
CHAPTER 13

myRA

Overview

On January 9, 2014, President Barrack Obama, through executive action, directed the Department of Treasury to create “myRA”—a simple, safe and affordable starter retirement savings account that will be offered through employers and will ultimately help millions of American begin to save for retirement.

This chapter will examine the basic rules of the “myRA” program, its Roth IRA similarities, who is eligible to contribute, how much can be contributed and how to set up the account.

Learning Objectives

Upon completion of this chapter, you will be able to:

- State the purpose of the myRA;
- Identify who can qualify for myRA;
- Explain the similarities of the myRA and Roth IRA; and
- Determine how the myRA works.

Background

In his 2014 State of Union address, President Barrack Obama, concerned about the lack of savings and the effects of the “great recession” of 2008-2009 had on the retirement safety of Americans, especially lower and middle income Americans who do not have an employer provided savings plan, announced myRA (My Retirement Account). The objective of the myRA program was a way for working Americans to start their own retirement savings. Based on independent analysis, it has been reported approximately half of all workers and 75 percent of part-time workers lack access to employer-sponsored retirement plans.

So, on January 9, 2014, the President took executive action to sign into law and direct the U.S. Department of the Treasury to develop the myRA program. In late 2014, the Treasury Department began a pilot program and developed a website for individuals and employers at: http://www.treasurydirect.gov/readysavegrow/readysavegrow.htm.
According to their website, the goal of the myRA was “to offer a new retirement savings account for individuals looking for a **simple**, **safe**, and **affordable** way to start saving.”

Next, let’s review some of the basics of the myRA program

### The Basics

In certain ways, a myRA is similar to a Roth IRA. In the Treasury’s own words, they describe the myRA as:

> “The myRA retirement savings account will be a Roth IRA account and have the same tax treatment and follow the rules of Roth IRAs.”

Annual income limitations will increase $1,000 for 2017 ($133,000 for individuals; $196,000 for married couples), and the maximum annual contribution is $5,500. Contributions are made with after-tax dollars and earnings and withdrawals are tax-free. In fact, the myRA isn’t only similar to a Roth—once it reaches $15,000, it will have to be rolled over into a Roth IRA.

### Benefits of myRA

MyRA is a simple, safe and affordable Roth IRA. Table 13.1 illustrates the features and benefits of the myRA.

**Table 13.1**

**MyRA Features and Benefits**

<table>
<thead>
<tr>
<th>Simple</th>
<th>Safe</th>
<th>Affordable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits are automatic every pay period</td>
<td>Contributions never go down in value</td>
<td>No cost to open an account</td>
</tr>
<tr>
<td>Portable – not tied to a single employer</td>
<td>Low-risk</td>
<td>Contribute any amount ($50, $25, $7)</td>
</tr>
<tr>
<td>Contributions can be withdrawn tax-free</td>
<td>Investment is backed by the U.S. Treasury</td>
<td>No fees</td>
</tr>
<tr>
<td>Earnings can be withdrawn tax-free after five years and the individual is age 59 ½ or older</td>
<td>Information is private and secure</td>
<td>Roth IRA tax advantages</td>
</tr>
</tbody>
</table>

Source: U.S. Treasury; myRA.treasury.gov

### Who Qualifies to Set Up myRA

MyRAs are designed for workers who do not have access to or are ineligible for an employer-sponsored retirement savings plan. It is intended for savers who seek a simple
starter retirement savings account with no minimum contribution amount required. myRA is initially available through participating employers.

As was discussed above, the myRA follows the Roth IRA rules, and is available to anyone with earned income of less than $133,000 for individuals and $196,000 for couples who file taxes jointly in 2017 (up from $132,000 and $194,000 in 2016), and who have a Social Security Number or Individual Taxpayer Identification Number (ITIN). These limits are subject to annual cost-of-living adjustments determined by the IRS.

MyRA is not intended to replace existing retirement savings, including employer-sponsored retirement plan offerings. For employees who are eligible for an employer-sponsored plan, such as a defined contribution plan, saving for retirement in those accounts may enable them to benefit from existing incentives for saving, such as an employer match.

How myRA Works

With contributions to a myRA, the investment earns interest and grows within the myRA. Contributions to the myRA are invested in a U.S. Treasury retirement savings bond, which is backed by the U.S. Treasury Department. The interest rate is the same variable rate as the Government Securities Investment Fund in the Thrift Savings Plan (TSP) for federal employees.

An individual can contribute up to $5,500 per year, or $6,500 for those over 50 in 2017. This is the annual contribution limit for all Roth IRA accounts, so if you have another Roth IRA in addition to your myRA, the total you contribute to both of those accounts cannot exceed $5,500 (or $6,500, if you are over 50).

The myRA must be set up through a payroll direct deposit from the individual’s employer. To set up a payroll direct deposit, the individual will need to complete a direct deposit authorization form and provide it to his/her employer to set up their automatic contributions. Allow on average approximately two pay periods for your first contribution to take place once your employer has processed your request.

A direct deposit authorization form can be accessed online through the myRA website. Note: Some employers may require use of their own authorization forms.

Once the myRA balance reaches $15,000, or after 30 years, whichever occurs first, the entire balance must be transferred to a private-sector Roth IRA.
MyRA Portability

MyRAs are linked to an individual, not to an employer, which makes it portable. Additionally, myRAs can receive contributions from multiple sources simultaneously. For example, if you shift jobs, you can continue to contribute to a myRA by setting up contributions through another employer that offers payroll direct deposit. If you have multiple jobs, you may request a payroll direct deposit through paychecks from any employer to contribute to a single myRA. To do so, you will need to complete a direct deposit authorization form with each employer.

Taking Withdrawals

Principal contributions can be withdrawn through your myRA at any time tax-free. Any interest earnings can be withdrawn tax-free after five years and age 59½; otherwise there may be penalties.

MyRA Program Trustee

Comerica Bank has been selected to administer the myRA program. The U.S. Office of Personnel Management is among the employers participating in the initial phase.

Treasury Ends MyRA Program

Due to “extremely low” demand and high costs, the Treasury Department has decided that it is ending the myRA retirement savings program. According to Treasury, the program has cost nearly $70 million since 2014, and would cost $10 million a year in the future.

Since its inception back in 2015, only 30,000 myRA accounts have been opened ($34 million in contributions). And 20,000 of the accounts had a median balance of $500 and 10,000 had a zero balance.

What Happens Next

The Treasury will phase out the program over the next few months, requiring myRA account holders to either roll over their accounts to Roth IRAs or close the accounts. Any myRA with a zero balance as of September 15, 2017 or later will be subject to “possible automatic closure,” the Treasury Department says. The administration is encouraging them to visit the myRA.gov site or call the customer support line at 855-406-6972 weekdays for additional information.
Chapter 13
Review Questions

1. True or False. In some ways, a myRA is similar to a Roth IRA.

   ( ) A. True
   ( ) B. False

2. What is the income threshold for a single taxpayer who is looking to contribute to a myRA in 2017?

   ( ) A. $133,000
   ( ) B. $ 71,000
   ( ) C. $194,000
   ( ) D. $118,000

3. What is the maximum allowable regular annual contribution to a myRA in 2017?

   ( ) A. $6,500
   ( ) B. $5,500
   ( ) C. $2,000
   ( ) D. $3,000

4. What is the income limit for a married couple filing jointly looking to contribute to their myRA in 2017?

   ( ) A. $132,000
   ( ) B. $ 71,000
   ( ) C. $196,000
   ( ) D. $118,000

5. In 2017, Tom (age 62) contributed $4,000 to his Roth IRA. If Tom is eligible to contribute to a myRA, how much can he contribute to his myRA in 2017?

   ( ) A. $2,000
   ( ) B. $9,000
   ( ) C. $6,500
   ( ) D. $2,500
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CHAPTER 14

COVERDELL EDUCATION SAVINGS ACCOUNT

Overview

Originally referred to as an Education IRA, the Coverdell Education Savings Account is actually a non-deductible education savings account. The investment earnings from this account accrue and are withdrawn tax-free if the proceeds are used to pay qualified education expenses of the account beneficiary.

This chapter will provide a review of the Coverdell Education Saving Account (CESA). It will define a CESA, how a taxpayer can establish a CESA, its tax advantages, define who can be a beneficiary (student), determine how much can be contributed, and then explain the rules for withdrawal and rollovers. We will also look at how to coordinate the CESA with other types of education funding plans, such as the Hope Credit, Lifetime Leaning Credit and Qualified Tuition Plans (Section 529 Plans).

Learning Objectives

Upon completion of this chapter, you will able to:

- State the purpose of Coverdell Education Savings Account (CESA);
- Identify the steps needed to set up a CESA;
- Determine qualifications for a CESA;
- Apply the rules for contributions and withdrawals from a CESA;
- List qualified higher education expenses;
- Explain how ATRA of 2012 permanently extends the tax credits for CESAs;
- Coordinate other tax credits with the CESAs; and
- Offer Hope Credit and Lifetime Learning Credits.

Background

The Taxpayer Relief Act of 1997 introduced a new type of tax-sheltered savings account, named the “Education IRA.” Despite the fact that the abbreviation IRA has traditionally stood for “individual retirement arrangement” and, the Education IRA has nothing to do with retirement, it was designed to help save and fund a “student’s” future college costs. This nomenclature was undoubtedly based upon the fact that the Education IRA mirrors the retirement IRA model in many of its tax characteristics.
The benefits of Education IRAs were substantially expanded under the Economic Growth and Tax Relief Reconciliation Act of 2001, and their tax-deferred status was maintained by the Pension Protection Act of 2006. Today these accounts are referred to as Coverdell Education Savings Accounts (CESAs).

The American Taxpayers Relief Act (ATRA) of 2012 permanently extended the tax provisions of Coverdell Education Savings Accounts (see Table 14.1).

<table>
<thead>
<tr>
<th>Table 14.1</th>
<th>Coverdell Education Savings Account (CESA)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2000</strong></td>
<td><strong>2017 and beyond</strong></td>
</tr>
<tr>
<td><strong>Contribution Limit:</strong> $500</td>
<td><strong>Contribution Limit:</strong> $2,000. Allow corporations and other entities to contribute to a CESA. Allow contributions until April 15 of the following year. Modify the phase-out range for married taxpayers.</td>
</tr>
<tr>
<td><strong>Earnings:</strong> Any earnings withdrawn were taxed as ordinary income and subject to a 10% penalty unless they are used for college expenses. In other words, your original contributions are not taxed but the appreciation will be.</td>
<td><strong>Earnings:</strong> Withdrawals from a CESA that are used to pay expenses from kindergarten through 12th grade are tax-free.</td>
</tr>
<tr>
<td><strong>Expenses:</strong> Qualified spending was limited to college-related expenses.</td>
<td><strong>Special Needs Beneficiaries:</strong> Allow CESA contributions for special needs beneficiaries above age 18.</td>
</tr>
<tr>
<td><strong>Hope and Lifetime Learning Credit:</strong> You were not allowed to claim both credits in the same year that you make a withdrawal.</td>
<td><strong>Expenses:</strong> Qualified spending includes kindergarten through 12th grade, plus college-related expenses.</td>
</tr>
<tr>
<td></td>
<td><strong>American Opportunity Credit and Lifetime Learning Credits:</strong> These credits can be claimed the same year a withdrawal is made from a CESA.</td>
</tr>
</tbody>
</table>

**Establishing a CESA**

A Coverdell Education Savings Account (CESA) is a trust or custodial account that is created or organized in the United States exclusively for the purpose of paying the qualified elementary, secondary or higher education expenses of the designated beneficiary (student) of the account. The account must be designated as a Coverdell Education Saving Account when it is created in order to be treated as a Coverdell Education Savings Account for tax purposes.
Anyone, including the student, may open a CESA established on the student’s behalf, as long as the student is less than 18 years of age at the time of the contribution or is a “Special Needs Student” (discussed below). The person making the contribution—the “Donor”—does not have to be related to the student. In fact, ever since January 1, 2002, the donor can be a corporation or other entity.

Any donor may open a CESA with any bank, or other entity that has been approved to serve as a non-bank trustee or custodian of an individual retirement account (IRA), and the bank or entity is offering CESA. Other entities that wish to offer CESAs but are not approved to serve as IRA trustees or custodians may seek approval by following the same IRS procedures used for approval of other IRA non-bank trustees. (see IRS Notice 97-57, 1997-2 C.B. 308).

When establishing a CESA, the Adoption Agreement must be signed by the donor, and any and all forms, applications, certifications and other documents must be signed by the parent if the student has not yet reached the “age of majority” recognized by the laws of the state of student’s residence.

While the student remains a minor, the parent identified in the Adoption Agreement will exercise all of the rights and responsibilities of the student, including the selection and exchange of fund shares in which the CESA is invested. The custodian’s acceptance of the contribution to this CESA is conditioned on agreement by the parent of any student who is a minor to be bound by all of the terms and conditions of the Disclosure Agreement and the provisions set out in the Custodial Agreement. The student may notify the custodian in writing that he or she has reached the age of majority in the state where the student then resides (and provide any documentation the custodian may request verifying the fact that he or she has attained such age). Upon receiving such request (and documentation, if requested), the custodian will recognize the student as the individual controlling the account with power to exercise all rights and responsibilities related to the CESA, and the parent will thereafter have no control or power over the account.

The donor may revoke a newly established CESA at any time within seven days after the date on which he or she receives the required Disclosure Statement from the account custodian/trustee. A CESA established more than seven days after the date of receipt of this Disclosure Statement may not be revoked.

Upon the death of the student, the account may pass to a beneficiary who has been designated as such and who is a qualifying member of the student’s family (this is explained below). If the account does not pass to such a beneficiary, any balance in the account should be withdrawn by the appropriate representative of the student’s estate within 30 days of the date of death (if not so withdrawn), the taxable amount will nevertheless be treated for income tax purposes as if it had been withdrawn.
CESA Contributions

A CESA is established on behalf of the student and is controlled by the student (or parent). The donor making a contribution, if not the student or parent, may designate the initial investments in the CESA, but shall have no further rights, interests, or obligations related to the CESA, except that he or she can make additional contributions, subject to the limits described below.

CESA Contribution Limits

The maximum cash contribution that may be contributed to a CESA for a designated beneficiary (student) for a particular year is $2,000 (not indexed with inflation). The limit is generally reduced if a donor’s modified adjusted gross income (MAGI) is between $95,000 and $110,000, or if married filing jointly, between $190,000 and $220,000 (not indexed for inflation). For most taxpayers, MAGI is the same as adjusted gross income (AGI) adding back several deductions if claimed (as was discussed in Chapter 2). Table 14.2 shows the MAGI limits for CESA contributions (limits are the same as 2016).

Table 14.2
2017 MAGI Limits for CESA Contributions

<table>
<thead>
<tr>
<th>If Donor is a Single Filer and/or Married Filing Separately</th>
<th>If Donor is Married Filing Jointly</th>
<th>Then Donor May Make</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $95,000</td>
<td>Up to $190,000</td>
<td>Full Contribution</td>
</tr>
<tr>
<td>More than $95,000 but less than $110,000</td>
<td>More than $190,000 but less than $220,000</td>
<td>Reduced Contribution (see explanation below)</td>
</tr>
<tr>
<td>$110,000 and up</td>
<td>$220,000 and up</td>
<td>Zero (No Contribution)</td>
</tr>
</tbody>
</table>

If the donor’s MAGI falls in the reduced contribution range, that donor’s contribution limit must be calculated. To do this, multiply the normal contribution limit ($2,000) by a fraction. The numerator is the amount by which MAGI exceeds the lower limit of the reduced contribution range ($95,000 if single, or $190,000 if married filing jointly). The denominator is $15,000 (single taxpayers) or $30,000 (married filing jointly). Subtract the amount obtained from multiplying from the normal limit.
**Example:** Assume that a donor’s MAGI for the year is $197,555 and he/she is married, filing jointly. The CESA contribution limit would be calculated as follows:

Step 1: The amount by which MAGI exceeds the lower limit of the reduced contribution range: $197,555 - $190,000 = $7,555

Step 2: Divide this by $30,000:

\[
\frac{7,555}{30,000} = 0.25183
\]

Step 3: Multiply this by the normal contribution limit of $2,000:

\[
0.25183 \times 2,000 = 503.66
\]

Step 4. Subtract this from the $2,000 contribution limit:

\[
2,000 - 503.66 = 1,496.34
\]

is the contribution limit.

Parents who are restricted from contributing to a CESA for a child can circumvent the income limitations by making a cash gift to their child who then contributes to the CESA. The contribution is considered a gift to the child. However, due to the low contribution limit for CESAs, the gift should be well under the allowed annual gift-tax exclusion amount ($14,000, for 2017 per donee), which should help avoid gift-tax concerns. Or another person may be willing to contribute so that the full $2,000 per year that the law allows will be added to the student’s CESA.

Total annual contributions per beneficiary are also limited to $2,000. If more than one CESA has been set up for a beneficiary, the total annual limit for all of the accounts is $2,000 regardless of how many donors contribute. Contributions to CESAs must be made in cash. Contributions may not be invested in life insurance or be commingled with other property except in a common trust or investment fund. The student’s interest in the account must be non-forfeitable at all times.

**Reminder:** The annual contribution deadline is April 15 of the following year. The annual contribution to a CESA does not count against the maximum that may be invested in the donor’s other IRAs. Also, after ATRA of 2012, contributions to a CESA can be made by corporations and other entities.

**Excess Contribution Penalty**

Similar to a Traditional IRA, a six (6) percent excise tax applies to CESA contributions that exceed $2,000 for any beneficiary. The penalty is imposed on the beneficiary (IRS Form 5329). The excise tax does not apply if the excess contributions (and any earnings) are withdrawn before the first day of the sixth month (June 1) of the following year. The withdrawn earnings are taxable for the year in which the excess contribution was made. ATRA of 2012, repeals the excise tax on contributions made to CESA when contribution made by anyone on behalf of same beneficiary to a qualified tuition program (QTP).
Special Needs Beneficiary

ATRA expands the contributions to a CESA for a “special needs” beneficiary after the beneficiary reaches age 18. Also, the CESA of a special needs beneficiary does not have to be emptied at age 30. The definition of “special needs” has not yet been established. Congress wants the IRS definition to include an individual who, because of a physical, mental, or emotional condition (including a learning disability), requires additional time to complete his or her education.

Tax-Free Income Compounding In a CESA

Table 14.3, presents a simple illustration of the power of tax-free compounding in a Coverdell Education Savings Account established for a child at birth in 2017 or thereafter, and maintained in annual installments at the maximum $2,000 annual contribution level. Income is computed at 6 percent per annum.

<table>
<thead>
<tr>
<th>Age At Contribution</th>
<th>Year-End Value Of CESA*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Birth</td>
<td>$2,120</td>
</tr>
<tr>
<td>5 years of age</td>
<td>$14,788</td>
</tr>
<tr>
<td>10 years of age</td>
<td>$31,740</td>
</tr>
<tr>
<td>18 years of age</td>
<td>$71,571</td>
</tr>
<tr>
<td>Total available for qualified education expenses at age 18</td>
<td>$71,571*</td>
</tr>
</tbody>
</table>

*If the interest rate assumption is increased to 8 percent, the amount available at age 18 would be $89,364.

Withdrawals from the CESA

A distribution (withdrawal) from a CESA can be made by the student at any time. If the distribution (withdrawal) meets the requirements discussed below, it is tax-free [IRC § 530 (b)]. This means that no federal income tax is due, even though the distribution (withdrawal) includes dividends or gains on the fund shares while held in the CESA. This is the case regardless of whether the student is enrolled full-time, half-time, or less than half-time. If the total distribution (withdrawal) for a tax year exceeds the qualified education expenses (see below), a portion of the distribution (withdrawal) is taxable to the beneficiary. The taxable portion is the amount of the excess distribution (withdrawal) allocable to earnings; see the example (for further review of the calculation review the worksheet in IRS Publication 970). The taxable portion is a pro-rata portion of the earnings that have accumulated tax-free in the account. The taxable portion of the
distribution (withdrawal) is also subject to a 10 percent additional to tax unless one of the following exceptions applies [IRC § 530(d) (4)(B) and (C)(i)]:

- If the withdrawal is made on or after the death of the designated beneficiary;
- If the withdrawal is attributable to the student’s being disabled;
- If the withdrawal is made on account of a scholarship, allowance or payment described in IRC § 25A (g)(2) received by the student, to the extent that the withdrawal does not exceed the amount of the scholarship allowance or payment; and
- If an amount contributed with respect to a given year is subsequently distributed prior to the first day of the sixth month (generally, prior to June 1) of the following year.

Each time a withdrawal is made from a CESA, the amount withdrawn is considered partly accumulated income and partly a return of contributions. This allocation is based upon the ratios of contributions and accumulated income, respectively, to the total balance in the account as of the date of withdrawal.

**Example:** If a $500 withdrawal is taken at a time when the account consists of $6,000 in contributions and $2,000 of accumulated income, one-fourth of the amount withdrawn, or $125 will be considered a withdrawal of income and three-fourths, or $375, will be considered withdrawal of contributions. In each succeeding computation the cumulative income and contribution totals in the account are reduced by the portions of each that were included in prior withdrawals.

It is important to remember that none of the income portion withdrawn is required to be included in the student’s taxable income if the entire amount of the withdrawal (income and principal) is used for qualified education expenses. If less than the entire amount of the withdrawal is used for qualified education expenses, a further pro-ration must be made. A portion of the income portion of the amount withdrawn must be included in the student’s gross income. This is based upon the ratio of the amount not spent for qualified education expenses over the total amount withdrawn. Thus, in the foregoing example, where $500 was withdrawn (including $125 of income from the account), if only $200 was spent on qualified education expenses and $300 was not so spent, then 3/5 ($300/$500) of the withdrawn income must be recognized. This would be $75 (3/5 x $125). This recognized income would also be subject to the 10 percent addition to tax unless one of the exceptions applies.

Any amount remaining in the account as of the student’s 30th birthday must be withdrawn by the student within 30 days after their birthday, and any dividends or gains will be then subject to income tax and penalty (unless an exception applies). The student can avoid these tax consequences if, before they reach age 30, the CESA is rolled over or transferred.
Qualified Higher Education Expenses

For tax years prior to 2002, Education Savings Accounts were directed exclusively toward higher education expenses, meaning college level and higher. Effective for tax years beginning in 2002 and thereafter, the utility of CESAs was expanded to include elementary and secondary education expenses. Thus, beginning in 2002, “qualified education expenses” include both “qualified higher education expenses” and “qualified elementary and secondary education expenses.” Prior to 2002, tax-free withdrawals could be taken only for qualified higher education expenses.

“Qualified higher education expenses” mean expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible educational institution [IRC § 529(e)(3)], and expenses for special needs services in the case of a Special Needs Student. Qualified higher education expenses include room and board charges for students who are at least half time and reside in school-owned housing. It also includes room and board for students not living in school-owned housing, but limited to an amount equal to the allowance for room and board included in the cost of attendance (as defined in section 472 of the Higher Education Act of 1965 [20 USC 108711], as in effect on June 7, 2001) as determined by the educational institution.

For purposes of the foregoing rule, a student will be considered to be enrolled at least half-time if the student is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. The institutions standard for a full-time workload must equal or exceed the standards established by the Department of Education as set forth in regulations under the Higher Education Act [34 C.F.R. §674.2(b)].

An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 USC 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. The same eligibility requirements for institutions apply for early withdrawals from IRAs for qualified higher education expenses.

Note: CESAs may impact financial aid eligibility. They are considered assets of the account owner; if owned by the student or parent, CESAs are considered parental assets, and this generally has less impact on financial aid.

Qualified Elementary and Secondary Education Expenses

For years beginning after 2001, withdrawals may be taken for “qualified elementary and secondary education expenses,” defined as including the following, with respect to
enrollment or attendance at an elementary or secondary public, private or religious school (kindergarten through grade 12) [IRC § 530(b)(4)]:

- Tuition, fees, academic tutoring, special needs services, books, supplies and other equipment;
- Room and board, uniforms, transportation, and supplementary items and services (including extended day programs); and
- Computer technology or equipment or internet access or related services to be used during any year of school attendance (excluding software for sports games or hobbies, unless predominantly educational in nature).

**Note:** ATRA of 2012 expands the definition of qualified expenses to include certain computers and related items.

### Withdrawals for Contributions to IRC § 529 Plans

Qualified education expenses also include amounts contributed to a qualified state tuition program (under IRC § 529). However, such non-taxable withdrawals from a CESA will not be deemed to increase the tax basis in the qualified state tuition plan account [IRC § 530(b)(2)(B)].

### CESA Rollovers

Any amount distributed from a CESA and rolled over to another CESA for the benefit of the same student (designated beneficiary) or certain members of the student’s family is not taxable. An amount is rolled over if it is paid to another CESA on a date within 60 days after the date of the distribution. Members of the student’s family include the student’s children and their descendants, stepchildren and their descendants, siblings and their children, parents and grandparents, step-parents, and spouses of all the foregoing. The annual contribution limit to CESA does not apply to these rollover contributions. For example, an older brother who has $3,000 left in his CESA after he graduates from college can roll over the full $3,000 balance to a CESA for his younger sister who is still in high school without paying any tax on the transfer.

Rather than rolling over money from one CESA to another, the student of the account may be changed from one child to another without triggering a tax, provided that:

- The terms of the particular trust or custodial account permit a change in the student (designated beneficiaries). **Note:** Each trustee or custodian will control whether options like this one are available in the accounts they offer; and
- The new student is a member of the previous student’s family.
Disposition of Balance after Conclusion of Education

If there are still assets remaining in a CESA after the student’s finishes his/her education, there are four options:

- First, the amount remaining in the account may be withdrawn for the student. The distributee of the withdrawn funds will be subject to both income tax and the additional 10 percent tax on the portion of the amount withdrawn that represents earnings if the student does not have any qualified education expenses in the same taxable year he/she makes the withdrawal;
- Second, the amount in the student’s CESA may be withdrawn and rolled over (as described above) to another CESA, or contributed to a IRC § 529 tuition plan, for the benefit of a member of the student’s family; the amount rolled over will not be taxable;
- Third, the student of the account may be changed to another member of the student’s family (as described above); and
- Fourth, the balance may be left in the account until age 30. If not sooner distributed, it will be deemed to have been distributed to the student (with attendant tax consequences, as in alternative number (1) above) 30 days after the student attains age 30. Thereafter, any income from the accounts assets will be deemed income of the student and no longer advantaged by the tax shelter of the CESA [IRC §§ 530(b)(1)(E) and 530(d)(8)].

Coordination with Tax Credits

Eligibility for education credits is based upon when expenses are PAID (either out-of-pocket or by borrowing). Regarding expenses paid in advance, they are still eligible expenses as long as the classes start in the January to March period of the next year.

A student may be able to receive tax-free distributions from a CESA the same year that he/she claimed an American Opportunity Tax Credit or Lifetime Learning Credit. However, the expenses taken into account as the basis of an American Opportunity Tax Credit or Lifetime Learning Credit reduce eligible expenses for purposes of figuring the tax-free part of the withdrawal from the CESA. In other words, you can exclude CESA distributions from gross income and claim the American Opportunity Tax credit or Lifetime Learning credits as long as they are not used for the same expenses. Let’s take a moment to discuss the American Opportunity Tax Credit and Lifetime Learning Credit.

American Opportunity Tax Credit

The American Opportunity Tax Credit (AOTC) replaced the Hope Credit. It provides a credit for four years (as opposed to the first two years for the Hope Credit) of college expenses, and the maximum credit per student for taxable years beginning in 2017 is $2,500 per year (versus a $1,800 maximum under the Hope rules). The credit is based on
100% of the first $2,000, and 25% of the next $2,000, of tuition, fees and course material (including books) expenses paid during the tax year. 40% of the credit is refundable, provided the taxpayer is not:

- A child under the age of 18; or
- Under the age of 24, a full-time student and is not self-supporting.

As noted above, this credit begins to phase out for AGI in excess of $80,000 for singles, and $160,000 for married couples filing jointly (see Table 14.4). The credit is gone for singles whose AGI exceeds $90,000, and $180,000 for MFJ.

### Table 14.4
MAGI Limits for the American Opportunity Tax Credit, 2017

<table>
<thead>
<tr>
<th>Single, Head of Household, Widow(er)</th>
<th>Married Filing Jointly</th>
<th>Amount of Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $80,000</td>
<td>Up to $160,000</td>
<td>Full Amount $2,500</td>
</tr>
<tr>
<td>More than $80,000 but less than $90,000</td>
<td>More than $160,000 but less than $180,000</td>
<td>Reduced Credit</td>
</tr>
<tr>
<td>$90,000 and up</td>
<td>$180,000 and up</td>
<td>Zero (No Credit allowed)</td>
</tr>
</tbody>
</table>

**Note:** Credit is figured on IRS Form 8863. A taxpayer cannot claim the credit if also claiming the Lifetime Learning Credit in the same year. And, married taxpayers who are filing separately cannot claim either the Hope/American Opportunity Credit.

The taxpayer may be able to claim an American Opportunity Tax Credit in the same year in which the student received a distribution from either a CESA or a Qualified Tuition Program (QTP), but cannot use expenses paid with a distribution from either a CESA or a QTP as the basis for the American Opportunity Tax Credit. A taxpayer who owes no other tax can receive as a tax refund 40% of the $2,500 tax credit, for a maximum of $1,000.

**Note:** The American Taxpayers Relief Act of 2012 extended the American Opportunity Tax credit until December 31, 2017.

### Lifetime Learning Credit

Unlike the American Opportunity Tax Credit, the Lifetime Learning Credit may be claimed for higher education costs beyond the fourth year of post-secondary education and for non-degree courses that enable the student to acquire or improve job skills. In
addition to tuition, qualified expenses include student activity fees and course related books, supplies, and equipment that must be paid to the educational institution as a condition of enrollment or attendance. The maximum Lifetime Learning Credit is $2,000 annually, regardless of how many students the taxpayer is paying expenses for during the tax year.

In contrast to the American Opportunity Tax Credit, the Lifetime Learning Credit does not have a degree requirement or a workload requirement. There are no limits on the number of years for which the Lifetime Learning Credit can be claimed.

The Lifetime Learning Credit is 20% of the first $10,000 paid for qualified expenses for all eligible students in the family. Thus, the maximum Lifetime Learning Credit that can be claimed is $2,000 (20% of $10,000), subject to income phase-out. The 2017 Lifetime Learning Credit is phased out if MAGI is between $56,000 and $66,000 for a single filer, head of household, or qualifying widow(er), or between $112,000 and $132,000 on a joint return. No credit is allowed once MAGI reaches $66,000, or $132,000 on a joint return (see Table 14.5 and Table 14.6).

Note: Credit is figured on IRS Form 8863. A taxpayer cannot claim the credit if also claiming the Hope/Opportunity credit for the same student for the same year. And, married taxpayers who are filing separately cannot claim either the Hope/American Opportunity Credit or the Lifetime Leaning Credit.

### Table 14.5
**MAGI Limits for 2016 Lifetime Learning Credits**

<table>
<thead>
<tr>
<th>Single, Head of Household, Widow(er)</th>
<th>Married Filing Jointly</th>
<th>Amount of Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $55,000</td>
<td>Up to $111,000</td>
<td>Full Amount $2,000</td>
</tr>
<tr>
<td>More than $55,000 but less than $65,000</td>
<td>More than $111,000 but less than $131,000</td>
<td>Reduced Credit</td>
</tr>
<tr>
<td>$65,000 and up</td>
<td>$131,000 and up</td>
<td>Zero (No Credit allowed)</td>
</tr>
</tbody>
</table>

### Table 14.6
**MAGI Limits for 2017 Lifetime Learning Credits**

<table>
<thead>
<tr>
<th>Single, Head of Household, Widow(er)</th>
<th>Married Filing Jointly</th>
<th>Amount of Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $56,000</td>
<td>Up to $112,000</td>
<td>Full Amount $2,000</td>
</tr>
<tr>
<td>More than $56,000 but less than $66,000</td>
<td>More than $112,000 but less than $132,000</td>
<td>Reduced Credit</td>
</tr>
<tr>
<td>$66,000 and up</td>
<td>$132,000 and up</td>
<td>Zero (No Credit allowed)</td>
</tr>
</tbody>
</table>
Coordination with Other Types of Plans

A taxpayer may claim both the income exclusion for 529 plans and Coverdell Education Savings Account distributions for the same student in the same year. However, the qualifying expenses cannot be used for both. When determining the excludable amount for 529 plans and a Coverdell Education Savings Account distribution, qualifying expenses must be reduced by tax-free education benefits (i.e., scholarships and employer-provided education assistance) plus the amount of the qualifying expenses taken into the account in computing the education credit.

Qualified Tuition Programs (QTPs)

Beginning with the year 2002, contributions may be made to both a Coverdell Education Savings Account and a qualified state tuition program (QTP) under IRC § 529, subject only to the respective separate limitations for each program.

If, in any year the aggregate distributions from both programs exceed the eligible education expenses of the subject student for that year, the taxpayer/student must allocate the expenses between the two programs for purposes of applying their respective distribution limitation rules [IRC § 530(d)(2)(C)(ii)].

Distributions from IRAs

Distributions may be made from IRA accounts (Traditional IRAs and Roth IRAs) for the payment of qualified higher education expenses without affecting the amount that may also be withdrawn from a Coverdell Education Savings Account, as long as all such amounts are used for qualified higher education expenses. Withdrawals from a Traditional IRA will be subject to income tax, but not subject to the 10 percent addition to tax if used for qualified higher education expenses.

Disallowance of Benefits IRC § 162 and §135

If the payment of a qualified higher education expense (QHEE) would be eligible as a deduction under IRC § 162 (as relating to maintaining or improving occupational skills), the deduction is disallowed to the extent that it was covered by withdrawal from a Coverdell Educational Savings Account.

Similarly, the exclusion from income under IRC § 135 for amounts received from the redemption of qualified U.S. Savings Bonds and used for qualified higher education expenses is not applicable to the extent that such expenses are covered by withdrawals from a Coverdell Education Savings Account [IRC § 530(d)(2)(D)].
Chapter 14
Review Questions

1. Which of the following educational costs can be funded by a Coverdell ESA (CESA)?

   ( ) A. Private elementary
   ( ) B. Secondary school costs
   ( ) C. College related costs
   ( ) D. All of the above

2. The donor may revoke a newly established CESA at any time within ____ days after
   the date on which he or she receives the required Disclosure Statement from the
   Account custodian/trustee.

   ( ) A. 3
   ( ) B. 7
   ( ) C. 5
   ( ) D. 30

3. What is the maximum allowable contribution to a CESA in 2017?

   ( ) A. $ 500
   ( ) B. $1,500
   ( ) C. $2,000
   ( ) D. $4,000

4. Which of the following can be a donor to a CESA?

   ( ) A. Any individual
   ( ) B. Corporation
   ( ) C. Any entity
   ( ) D. All of the above

5. Which of the following would not be considered a qualified education expense for
   tax-free withdrawals from a CESA?

   ( ) A. Tuition
   ( ) B. Fees
   ( ) C. Software for sports games
   ( ) D. Books
### CHAPTER REVIEW

#### ANSWERS

<table>
<thead>
<tr>
<th>Chapter 1</th>
<th>Chapter 2</th>
<th>Chapter 3</th>
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<tr>
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<td>3. A</td>
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<td>4. C</td>
<td>4. D</td>
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<td>5. C</td>
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## APPENDIX
### IRA STATE CREDITOR EXEMPTIONS

<table>
<thead>
<tr>
<th>State</th>
<th>State Statute</th>
<th>IRA Exempt</th>
<th>Roth IRA Exempt</th>
<th>Special Statutory Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Ala. Code § 19-3B-508</td>
<td>Yes</td>
<td>No</td>
<td>References IRC 7701(a)(37, which does not mention Roth IRAs. In Re Navarre-no protection inherited IRAs</td>
</tr>
<tr>
<td>Alaska</td>
<td>Alaska Statute § 09.38.017(a)</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption does not apply to amounts contributed within 120 days before the debtor files for bankruptcy. Protects inherited retirement accounts (IRA and 403(b)-(a)(3).</td>
</tr>
<tr>
<td>Arizona</td>
<td>Arizona Revenue Statute Ann. §§ 33-1126 (C)</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption does not apply to a claim by an alternate payee under a QDRO. The interest of an alternate payee is exempt from claims by creditors of the alternate payee. The exemption does not apply to amounts contributed within 120 days before a debtor files for bankruptcy. Statute appears to protect inherited IRAs as well.</td>
</tr>
<tr>
<td>Arkansas</td>
<td>Arkansas Code Ann. § 16-66-220</td>
<td>Yes</td>
<td>Yes</td>
<td>A bankruptcy court held that the creditor exemption for IRAs violates the Arkansas Constitution—at least with respect to contract claims. Traditional IRA/403b contributions in excess of deductible limits not protected.</td>
</tr>
<tr>
<td>California</td>
<td>Cal. Civ. Proc. Code §§ 704.115;</td>
<td>Yes</td>
<td>No</td>
<td>IRAs are exempt only to the extent necessary to</td>
</tr>
<tr>
<td>State</td>
<td>Statute/Regulation</td>
<td>Exempt?</td>
<td>Available?</td>
<td>Description</td>
</tr>
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<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Colorado</td>
<td>Colo. Rev. Stat. § 13-54-102(s)</td>
<td>Yes</td>
<td>Yes</td>
<td>Any retirement benefit or payment is subject to attachment or levy in satisfaction of a judgment taken for arrears in child support; any pension or retirement benefit is also subject to attachment or levy in satisfaction of a judgment awarded for a felonious killing.</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Conn. Gen. Stat. § 52-321a</td>
<td>Yes</td>
<td>Yes</td>
<td>100% of interest in or amounts payable from IRA (except contributions less than 90 days before claim filed or fraudulent conveyance).</td>
</tr>
<tr>
<td>Delaware</td>
<td>Del. Code Ann. Title10§ 4915(a)</td>
<td>Yes</td>
<td>Yes</td>
<td>100% of assets held or amounts payable under an IRA. An IRA is not exempt from a claim made pursuant to Title 13 of the Delaware Code, which Title pertains to domestic relations order.</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>D.C.Code § 15-501(a)(9)(10) , 15-501(b)</td>
<td>Yes</td>
<td>Yes</td>
<td>Applies to residents or those who “earn livelihood” DC. $200 per month payments for principal supporter of family, $60 per month payments for any other person.</td>
</tr>
<tr>
<td>State</td>
<td>IRC Section</td>
<td>Exempt</td>
<td>Inherited</td>
<td>Notes</td>
</tr>
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</tr>
<tr>
<td>Florida</td>
<td>Fl. Stat. Ann. § 222.21</td>
<td>Yes</td>
<td>Yes</td>
<td>IRA is not exempt from claim of an alternate payee under a QDRO or claims of a surviving spouse pursuant to an order determining the amount of elective share and contribution. New statute broadly includes beneficiaries, inherited IRAs (2)( c), substantially compliant plans.</td>
</tr>
<tr>
<td>Georgia</td>
<td>Ga. Code Ann. § 44-13-100(a)(2.1)</td>
<td>Yes</td>
<td>No</td>
<td>IRAs are exempt only to the extent necessary for the support of the debtor and any dependent. Roth IRA not mentioned in statute, but protected if “necessary” by In re Bramlette.</td>
</tr>
<tr>
<td>Hawaii</td>
<td>HRS § 651-124</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption does not apply to contributions made to a plan or arrangement within three years before the date a civil action is initiated against the debtor.</td>
</tr>
<tr>
<td>Idaho</td>
<td>Idaho Code Ann. §§11-604A, 55-1011</td>
<td>Yes</td>
<td>No</td>
<td>The exemption only applies for claims of judgment creditors of the beneficiary or participant arising out of a negligent or otherwise wrongful act or omission of the beneficiary or participant resulting in money damages to the judgment creditor. Inherited IRAs protected per In re McClelland.</td>
</tr>
<tr>
<td>Illinois</td>
<td>735 IL CS §§ 5/12-704; 5/12-1006</td>
<td>Yes</td>
<td>Yes</td>
<td>100% of benefits, refunds and assets held in fund or system. Not inherited plans-In re Taylor.</td>
</tr>
<tr>
<td>State</td>
<td>Code Reference</td>
<td>Exempt</td>
<td>Protected</td>
<td>Exemption Details</td>
</tr>
<tr>
<td>------------</td>
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</tr>
<tr>
<td>Indiana</td>
<td>Ind. Code § 34-55-10-2(c)(6)</td>
<td>Yes</td>
<td>No</td>
<td>No statutory exemption. Roth 401(k) rollover may not be protected, non-deductible contributions to Traditional IRAs as well. Inherited IRAs not protected: In re Klipsch.</td>
</tr>
<tr>
<td>Iowa</td>
<td>Iowa Code § 627.6</td>
<td>Yes</td>
<td>Yes</td>
<td>No statutory exemption</td>
</tr>
<tr>
<td>Kansas</td>
<td>KSA § 60-2308(b)</td>
<td>Yes</td>
<td>Yes</td>
<td>100% of money or assets payable to or any interest in IRA. May protect inherited retirement plans as well (“shall be exempt from any and all claims of creditors of the beneficiary or participant”).</td>
</tr>
<tr>
<td>Kentucky*</td>
<td>Ky. Rev. Stat. Ann. 427.150(2)</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption does not apply to any amounts contributed to an individual retirement account if the contribution occurred within 120 days before the debtor filed for bankruptcy. The exemption also does not apply to the right or interest of a person in individual retirement account to the extent that right or interest is subject to a court order for payment of maintenance or child support.</td>
</tr>
<tr>
<td>Louisiana</td>
<td>LSA-RS § 20-33(1); LSA-RS § 13-3881D</td>
<td>Yes</td>
<td>Yes</td>
<td>No contribution to an IRA is exempt made less than one calendar year from the date of filing bankruptcy whether voluntary or involuntary, or the date writs of seizure are filed against the account. The exemption also does not apply to liabilities for alimony and child support.</td>
</tr>
<tr>
<td>State</td>
<td>Code</td>
<td>Allow</td>
<td>Allow</td>
<td>Exemption Details</td>
</tr>
<tr>
<td>------------</td>
<td>-------------------------------</td>
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<td>---------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Maine</td>
<td>Me. Rev. Stat. Ann. Title 14, § 4422(13)(E)</td>
<td>Yes</td>
<td>Yes</td>
<td>$15,000 or only to the extent reasonably necessary for the support of the debtor and dependents.</td>
</tr>
<tr>
<td>Maryland</td>
<td>Md. Code Ann. Cts. &amp; Jud Proc. § 11-504(h)</td>
<td>Yes</td>
<td>Yes</td>
<td>Ties protection to deductibility (unless Roth)</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Mass. Gen. L. Ch. 235, § 34A</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption does not apply to an order of court concerning divorce, separate maintenance, or child support, or an order of court requiring an individual convicted of a crime to satisfy a monetary penalty or to make restitution, or sums deposited in a plan in excess of 7% of the total income of the individual within 5 years of the individual’s declaration of bankruptcy or entry of judgment.</td>
</tr>
<tr>
<td>Michigan*</td>
<td>Mich. Comp. Laws 600.6023</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption does not apply to amounts contributed to an individual retirement account or individual retirement annuity if the contribution occurs within 120 days before the debtor files for bankruptcy. The exemption also does not apply to an order of the domestic relations court.</td>
</tr>
<tr>
<td>Minnesota</td>
<td>Minn. Stat. § 550.37</td>
<td>Yes</td>
<td>Yes</td>
<td>Exempt to a present value of $30,000 and additional amounts reasonably necessary to support the debtor, spouse, or dependents.</td>
</tr>
<tr>
<td>State</td>
<td>Code Reference</td>
<td>Yes/No</td>
<td>Yes/No</td>
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</tr>
<tr>
<td>Mississippi</td>
<td>Miss. Code Ann. § 85-3-1</td>
<td>Yes</td>
<td>Yes</td>
<td>Statue references IRC 408 (or corresponding provisions of successor law), unclear whether 408A qualifies.</td>
</tr>
<tr>
<td>Missouri</td>
<td>Mo. Rev. Stat. § 513.430.1(10(f)</td>
<td>Yes</td>
<td>Yes</td>
<td>If proceedings under Title 11 of United States Code are commenced by or against the debtor, no amount of funds shall be exempt in such proceedings under any plan or trust which is fraudulent as defined in Section 456.630 of Missouri Code (since repealed), and for the period such person participated within 3 years before the commencement of such proceedings. Includes inherited IRAs.</td>
</tr>
<tr>
<td>Montana</td>
<td>Mont. Code Ann. § 31-2-106(3)</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption excludes that portion of contributions made by the individual within one year before the filing of the petition of bankruptcy, which exceeds 15% of the gross income of the individual for that one-year period.</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Neb. Rev. Stat. § 25-1563.01</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption only applies to the extent reasonably necessary for the support of the Debtor and any dependent of the debtor.</td>
</tr>
<tr>
<td>Nevada</td>
<td>Nev. Rev. Stat. § 21.090(q)</td>
<td>Yes</td>
<td>Yes</td>
<td>The exemption is limited to $500,000 in present value held in an individual retirement account, which conforms w/Section 408..</td>
</tr>
<tr>
<td>State</td>
<td>Statute or Code</td>
<td>Exempt?</td>
<td>100%?</td>
<td>Notes</td>
</tr>
<tr>
<td>-------------</td>
<td>------------------------------------------</td>
<td>---------</td>
<td>-------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>New Jersey</td>
<td>NJSA 25:2-1(b)</td>
<td>Yes</td>
<td>Yes</td>
<td>100% of assets in and distributions from IRA, except for support claims.</td>
</tr>
<tr>
<td>New Mexico</td>
<td>NMS §§ 42-10-1, 42-10-2</td>
<td>Yes</td>
<td>Yes</td>
<td>A retirement fund of a person supporting another person is exempt from receivers or trustees in bankruptcy or other insolvency proceedings, fines, attachments, execution, or foreclosure by a judgment letter.</td>
</tr>
<tr>
<td>New York</td>
<td>NY C.P.L.R. § 5205(c)</td>
<td>Yes</td>
<td>Yes</td>
<td>100% of assets or interests in, or payments from, IRA, except for additions made within 90 days before interposition of claim on which judgment is entered or which is a fraudulent conveyance.</td>
</tr>
<tr>
<td>North Carolina</td>
<td>NC Gen. Stat. § 1C-1601</td>
<td>Yes</td>
<td>Yes</td>
<td>100% exempt</td>
</tr>
<tr>
<td>North Dakota</td>
<td>N.D. Cent. Code § 28-22-03.1(3)</td>
<td>Yes</td>
<td>Yes</td>
<td>The account must have been in effect for a period of at least one-year. Each individual account is exempt to a limit of up to $100,000 per account, with an aggregate limitation of $200,000 for all accounts. The dollar limit does not apply to the extent the debtor can prove the property is reasonably necessary for the support of the debtor, spouse or dependents.</td>
</tr>
<tr>
<td>Ohio*</td>
<td>Ohio Revised Code Ann. § 2329.66 (A)(10)</td>
<td>Yes</td>
<td>Yes</td>
<td>SEPs and SIMPLEs are not exempt</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>Okla. Stat. Title 31, § 1, § 1A 20</td>
<td>Yes</td>
<td>Yes</td>
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1, 1999.
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<th>Code Section</th>
<th>Exempt?</th>
<th>Reason</th>
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<tr>
<td>Oregon</td>
<td>ORS § 18.358</td>
<td>Yes</td>
<td>No information provided.</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>42 PA. Conn. Stat. § 8124</td>
<td>Yes</td>
<td>The exemption does not apply to amounts contributed to the retirement fund within one year before the debtor filed for bankruptcy.</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>Gen. Laws §§ 9-26-4(11), 9-26-4(12)</td>
<td>Yes</td>
<td>The exemption does not apply to an order of the courts pursuant to a judgment of divorce or separate maintenance, or an order of court concerning child support.</td>
</tr>
<tr>
<td>South Carolina</td>
<td>SC Code Ann. § 15-41-30(10)</td>
<td>Yes</td>
<td>The debtor’s rights to receive individual retirement accounts and Roth accounts is exempt to the extent reasonably necessary for the support of the debtor and any dependent of the debtor.</td>
</tr>
<tr>
<td>South Dakota</td>
<td>S.D. Codified Laws § 43-45-16 and 43-45-17 and 43-45-18</td>
<td>Yes</td>
<td>Exempts “certain retirement benefits” up to $1,000,000. Cites up § 401(a)(13) of IRC (Tax Qualified Plan Non-Alienation Provision).</td>
</tr>
<tr>
<td>Tennessee*</td>
<td>Tenn. Code Ann. § 26-2-105</td>
<td>Yes</td>
<td>No information provided.</td>
</tr>
<tr>
<td>Texas</td>
<td>Texas Property Code § 42.0021</td>
<td>Yes</td>
<td>100% of interest or payments from IRA. Specifically includes inherited IRA as well, and even has specific protection for 60 days rollovers.</td>
</tr>
<tr>
<td>Utah</td>
<td>UCA §§ 78-23-5(1)</td>
<td>Yes</td>
<td>The exemption does not apply to amount contributed or benefits accrued by or on behalf of a debtor within one year before the debtor files for bankruptcy.</td>
</tr>
<tr>
<td>State</td>
<td>Title/Code</td>
<td>Exempt</td>
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</tr>
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<td>Virginia</td>
<td>Va. Code Ann. § 34-34</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Washington</td>
<td>Wash. Rev. Code § 6.15.020(3)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>West Virginia</td>
<td>W. Va. Code § 38-10-4(i)(5)</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Wis. Stat. Ann. § 815.18(3)(j)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
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</table>

Source: “How Safe Is Your Pension? Creditor Protection For retirement Plans and IRAs,” Authors: Richard A. Nagle and Mark P. Altieri. **Note:** *Kentucky, Michigan, Ohio and Tennessee: The U.S. Court of Appeals for the Sixth Circuit ruled in Lampkins v. Golden, 2002 U.S. App, LEXIS 900, 2002-1 U.S.T.C. par50,216 (6th Cir 2002), that a Michigan statute exempting SEPs and IRAs from creditor claims was preempted by ERISA. The decision appears, however, to be limited to SEPs and SIMPLE IRAs. March 2016.*
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The Advisor’s Guide to IRAs
(2017 Edition)

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