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IRAs and Retirement Plans

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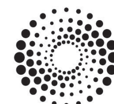

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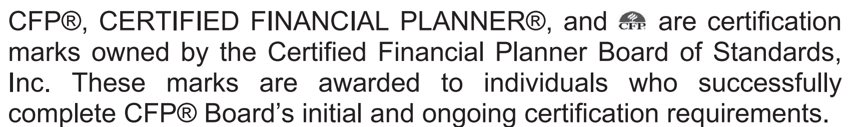
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INTRODUCTION

IRAs and Retirement Plans is an interactive self-study CPE course designed to enhance your understanding of the latest issues in the field. To obtain credit, you must log on to our Online Grading System at **OnlineGrading.Thomson.com** to complete the Examination for CPE Credit by **September 30, 2011**. Complete instructions are included below and in the Testing Instructions on page 131.

Taking the Course

You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied you understand the material, **answer the examination questions which follow each lesson** by recording your answer choices by logging on to our Online Grading System.

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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IRAs and Retirement Plans (DIRTG10)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course covers the requirements of traditional and Roth IRAs, Simple IRAs, SEP plans, 401(k) and 403(b) plans, as well as distributions and rollovers from the various plans.
PUBLICATION/REVISION DATE:	September 2010
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of taxation
CPE CREDIT:	4 QAS Hours, 4 Registry Hours
CTEC CREDIT:	4 Federal CTEC Hours, 0 California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. **Enrolled Agents:** This CPE course is designed to enhance professional knowledge for Enrolled Agents. Gear Up is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
CFP® CREDIT:	2 CE Hours – CFP® credit hours are one half the number of CPE credit hours.
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	**September 30, 2011**
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES

Lesson 1: Traditional IRAs

Completion of this lesson will enable you to:

- Identify the requirements of traditional IRAs and retirement annuities, determine contribution limits and requirements for IRAs, what is allowed for IRA contributions and how IRAs are transferred in divorce and inheritance.

Lesson 2: Roth IRAs

Completion of this lesson will enable you to:

- Recognize the differences between a Roth IRA and a traditional IRA, determine the requirements for contributing to a Roth IRA and identify the limits and ways to convert to and distribute from a Roth IRA.

Lesson 3: SIMPLE IRA Plans

Completion of this lesson will enable you to:

- Describe the various aspects of SIMPLE IRA plans, benefits, and requirements.

Lesson 4: SEP Plans

Completion of this lesson will enable you to:

- Identify the requirements of SEP plans.

Lesson 5: 401(k) and 403(b) Plans

Completion of this lesson will enable you to:

- Identify the various requirements of 401(k) and 403(b) plans, compare and contrast these types of plans, and determine the allowable contributions to these types of plans.

Lesson 6: Distributions

Completion of this lesson will enable you to:

- Determine when IRA and qualified plan distributions are allowed, when they are required, how much is taxable, and when penalties apply to the distribution.

Lesson 7: Rollovers

Completion of this lesson will enable you to:

- Determine the requirements for a tax-free rollover of all types of retirement plans and which types of plans can be rolled over into other types of retirement plans.

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- AuditWatch National School for Audit Leaders | San Francisco, July 15–16 & New York, August 19–20
- PPC and AuditWatch Accounting & Auditing Conference | Las Vegas, October 5
- PPC and AuditWatch Conference on Audit Quality & Efficiency | Las Vegas, October 6–7
- PPC Users' Conference: Best Practices in Implementing the PPC Approach | Las Vegas, October 8

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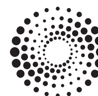
RIA Self-Study CPE

RIA and PPC's Complete Analysis of the Tax and Benefits Provisions of the American Recovery and Reinvestment Act, and RIA's 2010 Federal Tax Review. Download PDF at no cost from Checkpoint Learning!



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To enhance your learning experience, the final examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

Testing Instructions for Examination for CPE Credit 131

Lesson 1: Traditional IRAS

Learning Objectives

Completion of this lesson will enable you to:

- Identify the requirements of traditional IRAs and retirement annuities, determine contribution limits and requirements for IRAs, what is allowed for IRA contributions and how IRAs are transferred in divorce and inheritance.

What Is a Traditional IRA?

An individual retirement arrangement (IRA) can be either an individual retirement account or an individual retirement annuity. A traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA.

Tax advantages of a traditional IRA:

- Contributions to the IRA may be fully or partially deductible.
- Generally, amounts in a traditional IRA (including earnings and gains) are not taxed until distributed.
- Certain individuals can claim a tax credit for traditional IRA contributions.

Individual Retirement Accounts

An individual retirement account is a trust or custodial account created by a written document and set up in the U.S. for the exclusive benefit of an individual or his beneficiaries. The document must show that the account meets all of the following requirements:

1. The trustee or custodian is a bank, a federally insured credit union, savings and loan association or entity approved by the IRS to act as trustee or custodian. **Note:** An individual cannot be an IRA trustee.
2. The trustee or custodian generally cannot accept contributions of more than the contribution limit for the year. *Exception:* Rollover contributions and employer contributions to a simplified employee pension (SEP) can be more than this amount.
3. Contributions, except for rollover contributions, must be in cash.
4. The individual's interest in the account balance is nonforfeitable.
5. Funds in the account cannot be used to buy a life insurance policy.
6. Assets in the account cannot be combined with other property, except in a common trust fund or common investment fund.
7. The required minimum distribution (RMD) rules must be followed.

Individual Retirement Annuities

An individual retirement annuity can be set up by purchasing an annuity contract or an endowment contract from a life insurance company. An individual retirement annuity must be issued in the individual's name as the owner, and either he or his beneficiaries who survive him are the only ones who can receive the benefits or payments.

An individual retirement annuity must meet all the following requirements:

1. The owner's entire interest in the contract must be nonforfeitable.
2. The contract must provide that the owner cannot transfer any portion of it to any person other than the issuer.
3. There must be flexible premiums so that if the owner's compensation changes, his payment can also change (for contracts issued after November 6, 1978).
4. The contract must provide that contributions cannot be more than the contribution limit for an IRA for the year, and that the owner must use any refunded premiums to pay for future premiums or to buy more benefits before the end of the year after the year the refund is received.
5. The RMD rules must be followed.

Contribution Limit

Note: Contributions to a SEP IRA are subject to different limits than those described in this section. Also, SEP IRA contributions do not affect the contribution limit for other traditional IRAs.

Individuals can make IRA contributions any year that they are eligible to set up an IRA. Contributions must be in the form of money (cash, check or money order). Property cannot be contributed. *Exception:* Certain property (such as stock) may be transferred from one retirement plan to another.

For 2010, the maximum contribution (not counting rollovers) to a traditional IRA is the smaller of:

- $5,000 ($6,000 if age 50 or older at the end of the year), or
- Compensation for the year.

Example: George, age 34 and single, earns $24,000 in 2010. His IRA contributions for 2010 are limited to $5,000. Ethan, an unmarried college student working part time, earns $3,500 in 2010. His 2010 IRA contributions are limited to $3,500, the amount of his compensation.

This limit applies even if some or all of the contributions are nondeductible. *Exception:* Qualified reservist repayments are not counted toward this limit.

For individuals with more than one IRA, the limit applies to the total contributions made to all their traditional IRAs for the year.

Caution: Any contributions over the limit may be subject to a penalty tax.

Observation: Traditional IRA contributions reduce the taxpayer's annual limit on Roth IRA contributions.

Spousal IRAs

For 2010, if an individual files a joint return and his taxable compensation is less than his spouse's, the limit on contributions to his IRA for the year is the smaller of: [IRC §219(c)]

- $5,000 ($6,000 if age 50 or older) or
- The sum of the individual's and spouse's compensation, less contributions for the year made to the spouse's traditional or Roth IRA.

Thus, the total combined contributions that can be made for the year to both spouses' IRAs can be as much as $10,000 ($11,000 if only one is age 50 or older, or $12,000 if both are age 50 or older).

What Is Compensation?

For the IRA contribution limit, compensation is generally what is earned from working. For married individuals, compensation is computed separately, without considering any community property laws. Compensation includes the following:

Compensation for IRA Purposes	
Item	**Description**
Wages, Salaries, etc.	Any amount properly shown in box 1 (Wages, tips, other compensation) of Form W-2, provided that amount is reduced by any amount properly shown in box 11 (Nonqualified plans). This includes wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal service. Scholarship and fellowship payments are included only to the extent shown in box 1 of Form W-2.
Commissions	An amount received that is a percentage of profits or sales price is compensation.
Self-Employment Income	Net earnings from a self-employed individual's (sole proprietor's or partner's) trade or business (provided the taxpayer's personal services are a material income-producing factor) reduced by: 1) The deduction for contributions made to the self-employed person's retirement plans. 2) The deduction for one-half of their self-employment taxes. **Observation:** Compensation includes earnings from self-employment even if the earnings are not subject to SE tax because of the individual's religious beliefs. (Exemption generally obtained by filing Form 4029.) **Note:** Do not subtract a net loss from self-employment from salaries or wages when figuring total compensation.
Alimony	Any taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance.
Military Differential Pay	Payments made by some employers to employees who have been called to active duty in the uniformed services for a period of more than 30 days. These payments are reported in box 1 (Wages, tips, other compensation) of Form W-2.
Nontaxable Combat Pay	Nontaxable combat pay received by members of the U.S. Armed Forces. This amount should be reported in box 12 of Form W-2 with code Q.

What is not compensation? 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 (including social security benefits).
- Deferred compensation (compensation payments postponed from a past year).
- Income from a partnership if the taxpayer does not provide services that are a material factor in producing income.
- Any amounts (other than combat pay) excluded from income, such as foreign earned income and housing costs.

Contributing Less Than the Maximum

If contributions to a traditional IRA for a year are less than the limit for that year, additional contributions cannot be made after the due date of that year's return to make up the difference.

Example: Rafael, who is 40, earns $30,000 in 2010. Although he can contribute up to $5,000 to his IRA for 2010, he contributes only $3,000. After April 15, 2011, Rafael cannot make up the difference between his actual contributions for 2010 ($3,000) and his 2010 limit ($5,000). Any contributions made after April 15, 2011 through the end of 2011 are counted as 2011 contributions and subject to the 2011 limit. The "unused" 2010 limit is lost.

Contributing More Than the Maximum

If IRA contributions for a year are more than the limit, the excess contribution can be applied to a later year if the contributions for that later year are less than the maximum allowed for that year. However, a penalty tax may apply.

When Can Contributions Be Made?

Contributions can be made to a traditional IRA for each year that the account owner:

- Receives compensation, and
- Has not reached age 70½. Individuals reach age 70½ on the date that is six calendar months after the 70th anniversary of their birth. Thus, individuals born on or before June 30, 1940 cannot contribute to their own traditional IRA for 2010 or any later year.

Strategy: Compensation earned by a married taxpayer who is over age 70½ is still counted for determining his spouse's maximum contribution if they file a joint return and the spouse is under age 70½.

Observation: Individuals who do not work during the year can still make IRA contributions for that year if they received alimony, nontaxable combat pay or military differential pay, or if they filed a joint return with a spouse who had compensation.

Contributions Must Be Made By Due Date of Return

Contributions can be made to a traditional IRA for a year at any time during that year or by the due date (not including extensions) for filing the tax return for that year. For most individuals, this means that contributions for 2010 must be made by April 15, 2011.

Contributions made after year-end. If an amount is contributed to a traditional IRA between January 1 and April 15, it is necessary to tell the IRA trustee or custodian (sponsor) which year (the current or previous year) the contribution is for. If the individual does not tell the sponsor which year a contribution is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it).

Filing before a contribution is made. Taxpayers can file their return claiming a traditional IRA contribution before the contribution is actually made, as long as the contribution is made by the unextended due date of the return.

Contributions in the Year of Death

A decedent's estate cannot make contributions to the decedent's IRA or to a spousal IRA for the decedent's spouse. However, a nonworking spouse may make a contribution to a spousal IRA for the year of the decedent's death.

Example: Brian died on June 8, 2010. Before his death, he received $45,000 in earned income. His wife, Jamie, does not have any earned income. Brian's estate cannot make IRA contributions to his IRA or to a spousal IRA for Jamie. However, if she files a joint return with Brian for 2010, Jamie (age 40) can contribute up to $5,000 (lesser of $45,000 or $5,000) to her IRA for 2010 under the spousal IRA rules as long as she, and not Brian's estate, contributes the funds.

Variation: Same facts except that in February 2010, Brian made an IRA contribution. Since the contribution was made before his death, it is a qualifying contribution.

Deducting IRA Contributions

General Rule

Taxpayers who are not covered by an employer retirement plan during any part of the year can deduct contributions to their traditional IRA for the year, up to the contribution limit.

2010 IRA Deduction Limit	
Under age 50	$5,000 (or compensation, if less)
Age 50 or older	$6,000 (or compensation, if less)

Trustees' fees. Trustees' administrative fees that are billed separately and paid in connection with a traditional IRA are not deductible as IRA contributions. However, they may be deductible as a miscellaneous itemized deduction on Schedule A (Form 1040).

Brokers' commissions. If paid by the account owner (rather than out of funds in the IRA), these commissions are part of the IRA contribution and are deductible, subject to the deduction limits.

Individuals Covered By Employer Retirement Plans

If an individual (or his spouse) is covered by an employer retirement plan, he may not be able to deduct the full amount of his traditional IRA contributions. The deductible amount begins to decrease (phase out) when modified AGI rises above a certain amount and is eliminated altogether when it reaches a higher amount.

Nondeductible Contributions

Although the deduction for IRA contributions may be reduced or eliminated, IRA contributions can be made to the contribution limit. The difference, if any, between the contribution limit and the IRA deduction is a nondeductible contribution.

Example: Tony is 29 years old and single. In 2010, he was covered by a retirement plan at work. His salary is $57,312. His modified AGI is $68,000. Tony makes a $5,000 IRA contribution for 2010. Because he was covered by a retirement plan and his modified AGI is above $66,000, he cannot deduct his $5,000 IRA contribution. He must designate this contribution as a nondeductible contribution by reporting it on Form 8606.

Reporting Nondeductible Contributions

Form 8606 must be filed to designate contributions as nondeductible. Taxpayers do not have to designate a contribution as nondeductible until they file their tax return. Form 8606 must be filed to report nondeductible contributions even if the taxpayer does not have to file a tax return for the year. In that case, the Form 8606 is filed at the same time and with the same service center as the taxpayer would have filed a tax return if one were required.

Observation: Contributions in excess of the allowable deduction must be designated as nondeductible. But, taxpayers can choose to designate otherwise deductible contributions as nondeductible contributions.

Caution: Form 8606 is not used for the year that individuals roll over qualified retirement plan assets that included nontaxable amounts to a traditional IRA. In that situation, Form 8606 is completed for the year distributions are taken from that IRA.

Failure to report nondeductible contributions. If nondeductible contributions are not reported on Form 8606, all of the traditional IRA contributions are treated as deductible contributions when withdrawn. All IRA distributions will be taxed unless the taxpayer can show, with satisfactory evidence, that nondeductible contributions were made.

Penalty for overstatement. Overstating nondeductible contributions on Form 8606 results in a $100 penalty for each overstatement, unless it was due to reasonable cause.

Nondeductible Contributions Create Basis

Individuals who make nondeductible contributions to their traditional IRA will have basis in the IRA. The basis is the sum of the nondeductible IRA contributions minus any withdrawals or distributions of nondeductible contributions.

Observation: For taxpayers who have made nondeductible contributions, traditional IRA distributions will generally include both taxable and nontaxable (basis) amounts.

Excess Contributions

Generally, for 2010, an excess contribution is the amount contributed to an individual's traditional IRAs for the year that is more than the *smaller* of:

- 5,000 ($6,000 if age 50 or older) or
- Compensation for the year.

Note: The taxable compensation limit applies whether contributions are deductible or nondeductible.

Contributions for the year an individual reaches age 70½ (and any later years) are also excess contributions.

Observation: Roth IRA contributions can be made after individuals turn age 70½ without incurring the 6% penalty tax, provided no more than the allowable amount is contributed to the Roth IRA. This is an advantage of Roth IRAs over traditional IRAs.

An excess contribution can be the result of contributions made by the individual, his spouse or his employer contribution, or of an improper rollover contribution. *Exception:* Employer contributions to an employee's SEP IRA are subject to special rules.

IRA Transfers Related to Divorce

If a divorce or separate maintenance decree, or a written document related to such a decree, transfers an interest in a traditional IRA to the account owner's spouse or former spouse, the interest in the IRA, starting from the date of the transfer, is treated as the transferee spouse's IRA. The transfer is tax-free.

An interest in a IRA transferred under a decree of divorce or separate maintenance is treated as the recipient's IRA for all purposes. For example, if the transferee is over 70½ years old, required minimum distributions must begin (unless the IRA is a Roth IRA).

Caution: The transfer is tax-free only if it is specifically required by a decree of divorce or separate maintenance (or a written instrument related to such a decree). Thus, the couple must eventually divorce or legally separate. Transferring an IRA under a written separation agreement or other court order (for example a temporary support order) is not tax-free.

Even when the divorce or separate maintenance decree calls for the division of an IRA between the spouses, it is important that the IRA funds be transferred directly to the receiving spouse's IRA and not first distributed to the account owner.

Transfer Methods

Two commonly-used methods of transferring IRA assets to a spouse (or former spouse) are:

1. Changing the name on the IRA.
2. Making a direct transfer of IRA assets.

Changing the name on the IRA. If all the assets are to be transferred, the account can be transferred by changing the name on the IRA from the original owner's to the name of the recipient spouse (or former spouse).

Direct transfer. Under this method, the account owner directs the IRA trustee to transfer the affected assets directly to the trustee of a new or existing traditional IRA set up in the name of the account owner's spouse (or former spouse).

If the spouse (or former spouse) is allowed to keep his portion of the IRA assets in the account owner's existing IRA, the account owner can direct the trustee to transfer the assets he is permitted to keep directly to a new or existing traditional IRA set up in his name. The name on the IRA containing the spouse's portion of the assets would then be changed to show his ownership.

Inherited IRAs

Individuals who inherit an IRA are called beneficiaries. A beneficiary can be any person or entity the owner chooses to receive the benefits of the IRA after he dies. Like the original owner, individuals who inherit an IRA generally will not owe tax on the assets in the IRA until they receive distributions from it.

Note: Under the required minimum distribution rules, a traditional IRA must be distributed to the beneficiary over a certain period, which depends on the beneficiary's identity and the IRA owner's age at death.

Options for Spouses Who Inherit an IRA

Individuals who inherit a traditional IRA from their spouse generally have the following three choices:

1. Treat it as their own IRA by designating themselves as the account owner.
2. Treat it as their own by rolling it over into their IRA, or to the extent it is taxable, into a qualified employer plan, a Section 403(a) or 403(b) plan or a Section 457 plan.
3. Treat themselves as the beneficiary rather than treating the IRA as their own. In this case, special rules apply when computing the required minimum distributions from the IRA after the owner's death.

IRAs Inherited From Someone Other Than a Spouse

Individuals who inherit a traditional IRA from anyone other than their deceased spouse cannot treat the inherited IRA as their own. This means that they cannot make any contributions to the IRA. It also means they cannot roll over any amounts into or out of the inherited IRA. However, they can make a trustee-to-trustee transfer to a different IRA as long as the IRA into which amounts are moved is set up and maintained in the name of the deceased IRA owner for the individual's benefit as beneficiary.

IRA With Basis

The deceased owner's basis in the IRA (because of nondeductible contributions) remains with the IRA. However, other than a surviving spouse who chooses to treat the inherited IRA as his own, individuals who inherit an IRA cannot combine its basis with any basis they have in their own traditional IRA(s) or any basis in traditional IRA(s) inherited from other decedents.

Individuals who take distributions from both an inherited IRA and their own IRA, when each has basis, must complete separate Forms 8606 to determine the taxable and nontaxable portions of those distributions.

Tax Credit for IRA Contribution

Individuals who make eligible IRA (traditional or Roth) contributions may qualify for the retirement saver's credit of up to $1,000 ($2,000 if MFJ). The nonrefundable credit (figured on Form 8880) can offset regular tax and AMT.

Observation: Elective deferrals to a 401(k) or 403(b) plan (including designated Roth contributions), or to a 457, SEP or SIMPLE plan, also qualify for the saver's credit. Voluntary after-tax employee contributions to a tax-qualified retirement plan or 403(b) annuity also qualify. Employee contributions are treated as voluntary as long as they are not required as a condition of employment.

The credit amount is the eligible contribution multiplied by the credit rate, based on filing status and modified AGI. The maximum contribution taken into account is $2,000 per person. On a joint return, up to $2,000 is taken into account for each spouse.

Qualified individuals must meet all the following requirements to qualify for the credit in 2010:

- Be at least age 18 by the end of the year (born before January 2, 1993).
- Not be a full-time student.
- Not be a dependent claimed on someone else's tax return.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of a traditional IRA account or annuity by the account owner, the account beneficiary or any disqualified person.

Disqualified persons include the IRA fiduciary and members of the account owner's family (spouse, ancestor, lineal descendant and any spouse of a lineal descendant).

Examples of prohibited transactions with a traditional IRA include:

- Borrowing money from it.
- Selling property to it.
- Receiving unreasonable compensation for managing it.
- Using it as security for a loan.
- Buying property for personal use (present or future) with IRA funds.

Definition of fiduciary. For the prohibited transaction rules, a fiduciary includes anyone who does any of the following:

- Exercises any discretionary authority or control in managing an IRA or disposing of its assets.
- Provides investment advice to an IRA for a fee, or has any authority or responsibility to do so.
- Has any discretionary authority or responsibility in administering an IRA.

Loss of IRA Status

Generally, if the IRA owner or a beneficiary engages in a prohibited transaction in connection with a traditional IRA at any time during the year, the account stops being an IRA as of the first day of that year.

Effect on owner or beneficiary. If an account loses its status as an IRA because the owner or a beneficiary engaged in a prohibited transaction, the account is treated as distributing all its assets to the account owner at their FMV on the first day of the year. The total FMV in excess of any basis in the IRA is a taxable distribution that, in addition to income tax, may be subject to additional taxes or penalties (for example, the 10% early distribution penalty if the owner is under age 59½).

Exception: An IRA set up by an employer or an employee association does not lose its IRA status if the employer or the employee association engages in a prohibited transaction. This exception does not apply if the account owner participates in the prohibited transaction with his employer or the association.

Penalty Taxes on Prohibited Transactions

If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

Loss of IRA status. If the traditional IRA ceases to be an IRA because of a prohibited transaction by the account owner or a beneficiary, the person who engaged in the prohibited transaction is not liable for these excise taxes. However, the account owner may be subject to income tax due to the deemed distribution of the account.

Exempt Transactions

Two types of transactions are not prohibited transactions if they meet the requirements described below.

Payments of cash, property or other considerations to the account owner. Even if a sponsor makes payments to the account owner or his family, there is no prohibited transaction if all three of the following requirements are met:

1. The payments are for establishing a traditional IRA or for making additional contributions to it.

2. The IRA is established solely to benefit the account owner and his (or his spouse's) beneficiaries.
3. During the year, the FMV of the payments received is not more than:
   a) $10 for IRA deposits of less than $5,000 or
   b) $20 for IRA deposits of $5,000 or more.

Examples of the nominal gifts or banking services that an IRA owner can receive without creating a prohibited transaction include free checking, cash bonuses or other gifts, if the above requirements are met.

If the consideration is group term life insurance, requirements 1 and 3 do not apply if no more than $5,000 of the face value of the insurance is based on a dollar-for-dollar basis on the assets in the IRA.

Services received at reduced or no cost. Even if a sponsor provides services at reduced or no cost, there is no prohibited transaction if all of the following requirements are met:

1. The traditional IRA qualifying the account owner to receive the services is established and maintained for the benefit of the account owner, his spouse and his (or his spouse's) beneficiaries.
2. The bank itself can legally offer the services.
3. The services are provided in the ordinary course of business by the bank (or a bank affiliate) to customers who qualify but do not maintain an IRA (or a Keogh plan).
4. The determination, for a traditional IRA, of who qualifies for these services is based on an IRA (or a Keogh plan) deposit balance equal to the lowest qualifying balance for any other type of account.
5. The rate of return on a traditional IRA investment that qualifies is not less than the return on an identical investment that could have been made at the same time at the same branch of the bank by a customer who is not eligible for (or does not receive) these services.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following is a requirement of an individual retirement annuity?

   a. The funds placed in the account cannot be used to purchase a life insurance policy.

   b. The owner of the contract cannot transfer any portion of the contract to any person other than the issuer.

   c. All contributions added to the account for the year must be in cash.

   d. The assets held in the fund are not allowed to be combined with other property.

2. Steven, age 38, is self-employed and contributes to a traditional IRA account in 2010. Which of the following would ***not*** be deductible as an IRA contribution for Steven in 2010?

   a. Any brokers' commissions paid by Steven for funds allocated to the IRA.

   b. Amounts Steven contributes to the IRA account.

   c. Separately billed trustees' administrative fees paid in conjunction with the IRA.

3. Mark dies in 2010 and leaves his entire IRA account to his niece, Leslie. Which of the following is true for Leslie regarding the inherited IRA account?

   a. The IRA funds can be transferred to another IRA using a trustee-to-trustee transfer in Mark's name with Leslie as a beneficiary.

   b. Leslie can treat the IRA account as her own after inheriting it if she designates herself as the account owner.

   c. Leslie will owe taxes on the assets in the IRA when she inherits the IRA account from Mark, on his passing.

   d. Leslie can roll over the inherited IRA into her own IRA account, upon Mark's passing.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following is a requirement of an individual retirement annuity? **(Page 2)**

   a. The funds placed in the account cannot be used to purchase a life insurance policy. [This answer is incorrect. The stipulation that the funds in the account cannot be used to buy a life insurance policy is a requirement of an individual retirement account as stated in IRC Section 408(a).]

   b. The owner of the contract cannot transfer any portion of the contract to any person other than the issuer. [This answer is correct. According to the IRS Sec. 408(b), an individual retirement annuity must meet certain requirements. One of those requirements is that the contract must provide that the owner cannot transfer any portion of the contract to any person other than the issuer of the contract.]

   c. All contributions added to the account for the year must be in cash. [This answer is incorrect. A requirement of an individual retirement account, not an individual retirement annuity, is that all contributions, with the exception of rollover contributions, must be in cash as indicated in IRC Section 408(a).]

   d. The assets held in the fund are not allowed to be combined with other property. [This answer is incorrect. According to IRC Section 408(a), a requirement of an individual retirement account is that assets in the account cannot be combined with other property, except in a common trust fund or common investment fund. This is not a requirement of an individual retirement annuity.]

2. Steven, age 38, is self-employed and contributes to a traditional IRA account in 2010. Which of the following would ***not*** be deductible as an IRA contribution for Steven in 2010? **(Page 5)**

   a. Any brokers' commissions paid by Steven for funds allocated to the IRA. [This answer is incorrect. If the brokers' commissions are paid by the account owner, rather than out of funds in the IRA, the commissions are part of the IRA contribution and are considered deductible, although they are subject to the deduction limits.]

   b. Amounts Steven contributes to the IRA account. [This answer is incorrect. Taxpayers who are not covered by an employer retirement plan during any part of the year can deduct contributions to their traditional IRA for the year, up to the contribution limit, as stated in IRC Section 219(b).]

   c. Separately billed trustees' administrative fees paid in conjunction with the IRA. [This answer is correct. Trustees' administrative fees that are billed separately and paid in connection with a traditional IRA are not deductible as IRA contributions. However, they may be deductible as a miscellaneous itemized deduction on Schedule A of Form 1040.]

3. Mark dies in 2010 and leaves his entire IRA account to his niece, Leslie. Which of the following is true for Leslie regarding the inherited IRA account? **(Page 8)**

    a. The IRA funds can be transferred to another IRA using a trustee-to-trustee transfer in Mark's name with Leslie as a beneficiary. [This answer is correct. Individuals who inherit a traditional IRA from anyone other than their deceased spouse can make a trustee-to-trustee transfer to a different IRA as long as the IRA into which funds are moved is set up and maintained in the name of the deceased IRA owner for the individual's benefit as beneficiary.]

    b. Leslie can treat the IRA account as her own after inheriting it if she designates herself as the account owner. [This answer is incorrect. Individuals who inherit a traditional IRA from anyone other than their deceased spouse cannot treat the inherited IRA as their own. Since Leslie was Mark's niece and not his spouse, she will not be able to treat Mark's IRA account as her own and will not be able to make any contributions to the IRA account.]

    c. Leslie will owe taxes on the assets in the IRA when she inherits the IRA account from Mark, on his passing. [This answer is incorrect. Like the original owner, individuals who inherit an IRA generally will not owe tax on the assets in the IRA until they receive distributions from the IRA account.]

    d. Leslie can roll over the inherited IRA into her own IRA account, upon Mark's passing. [This answer is incorrect. Individuals who inherit a traditional IRA from anyone other than a deceased spouse cannot roll over any contributions into or out of the inherited IRA account. Since Leslie is not Mark's spouse, she will not be able to roll over the inherited IRA account into her IRA account.]

EXAMINATION FOR CPE CREDIT

Lesson 1

Determine the best answer for each question below. Then log on to our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

1. Greg and Lucy get married in 2010. Greg is 52 years old and currently earns $75,000 per year. Lucy is 45 years old and has decided to go back to school for her master's degree, so she is currently not working. They file a joint return for 2010. What is the total combined contribution that Greg and Lucy can contribute to an IRA in 2010?

   a. $5,000.

   b. $10,000.

   c. $11,000.

   d. $12,000.

2. Which of the following would be considered compensation when determining the IRA contribution limit?

   a. Rental income.

   b. Deferred compensation.

   c. Annuity income.

   d. Alimony.

3. Trey is 38 years old and single. He earns $85,000 in 2010. Trey is covered and participates in his retirement plan at work, but also contributes $5,000 to a traditional IRA in 2010. How much must Trey designate as a nondeductible contribution on Form 8606 in 2010?

   a. Trey does not have a nondeductible contribution for 2010.

   b. The $5,000 Trey contributed to his traditional IRA in 2010.

   c. The amount contributed by his employer to his retirement account in 2010.

   d. $5,000 plus the amount contributed by his employer to his retirement account in 2010.

Lesson 2: Roth IRAs

Learning Objectives

Completion of this lesson will enable you to:

- Recognize the differences between a Roth IRA and a traditional IRA, determine the requirements for contributing to a Roth IRA and identify the limits and ways to convert to and distribute from a Roth IRA.

What Is a Roth IRA?

A Roth IRA is an individual retirement plan that, unless specified, is subject to the rules that apply to a traditional IRA. However, as explained in this tab, there are several significant differences between the two.

Major Differences Between Roth and Traditional IRAs		
	Roth IRA	**Traditional IRA**
Contributions deductible?	No.	Yes.[1]
Distributions taxable?	No.[2]	Yes, to the extent they exceed basis.
Contribute after age 70½?	Yes.	No.
Required distributions during account owner's lifetime?	No.	Yes, starting for the year owner reaches age 70½.
Basis allocated to distributions?	No. Basis distributed before earnings.	Yes. A portion of total basis in all traditional IRAs is allocated to each distribution.

[1] Deduction may be phased out for individuals who are covered by an employer retirement plan.

[2] If a qualified distribution. If nonqualified distribution, distributions are taxable after basis is recovered.

Establishing a Roth IRA

To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. A deemed (payroll deduction) IRA can be a Roth IRA, but SEP IRAs and SIMPLE IRAs cannot be designated as Roth IRAs.

Contributing to a Roth IRA

No Deduction Allowed

Roth IRA contributions are not deductible. As nondeductible IRA contributions, they increase the owner's basis in the Roth IRA, which can be withdrawn tax-free, even if the distribution is not a qualifying distribution.

Who Can Contribute?

Generally, individuals can contribute to a Roth IRA in 2010 if:

1. They have compensation and
2. Their modified AGI is less than:
    a) $177,000 if MFJ or QW.
    b) $120,000 if single, HOH or MFS (only if individual lived apart from his spouse all year).
    c) $10,000 if MFS and lived with spouse at any time during the year.

No age limit for contributions. Unlike traditional IRAs, contributions can be made to a Roth IRA regardless of the account owner's age.

Compensation. Compensation is defined the same way as for traditional IRA contributions. It includes wages, salaries, tips, professional fees, bonuses and other amounts received for providing personal services. It also includes commissions, self-employment income, nontaxable combat pay, military differential pay and taxable alimony and separate maintenance payments.

Contribution Limit

The contribution limit for Roth IRAs depends on whether contributions are made only to Roth IRAs or to both traditional IRAs and Roth IRAs.

Roth IRA contributions only. If contributions are made only to Roth IRAs, the 2010 maximum contribution is the lesser of:

- $5,000 ($6,000 if age 50 or older) or
- Compensation.

However, if modified AGI is above a certain amount, the contribution limit may be reduced.

Contributions to both Roth and traditional IRAs. If an individual makes both Roth IRA and traditional IRA contributions for the same year, the Roth IRA contribution limit is reduced by contributions for the year to all IRAs other than Roth IRAs. *Exception:* Employer contributions (including a self-employed individual) under a SEP or SIMPLE IRA plan do not affect the Roth IRA contribution limit.

Contribution Limit Reduced Due to AGI

The Roth IRA contribution limit is reduced when modified AGI reaches certain levels.

Roth IRA Contribution Phase-Out (2010)	
Filing Status	**MAGI Phase-Out Range**
MFJ, QW	$167,000 – 177,000
Single, HOH	105,000 – 120,000
MFS*	0 – 10,000
* Individuals filing MFS who did not live with their spouse at any time during the year are treated as single.	

Roth IRAs for Spouses

Individuals can contribute to a Roth IRA for their spouse if the spouses file a joint return. The maximum contribution is the lesser of:

- $5,000 ($6,000 if age 50 or older) or
- The compensation limit for spousal IRAs.

Caution: The contribution limit is reduced when modified AGI exceeds certain levels.

Deadline for Making Contributions

Contributions can be made to a Roth IRA for a year at any time during the year or by the due date of the return for that year (not including extensions).

Strategy: Individuals can make Roth IRA contributions for 2010 by the due date (not including extensions) for filing their 2010 tax return. This means that most people must make contributions for 2010 by April 15, 2011.

Converting IRAs to Roth IRAs

Account owners may be able to convert amounts from either a traditional, SEP or SIMPLE IRA into a Roth IRA. **Note:** For this discussion of converting to a Roth IRA, the term *traditional IRA* includes SEP and SIMPLE IRAs.

Pre-2010 AGI limit on conversions. Before 2010, only individuals whose modified AGI was $100,000 or less could convert a traditional IRA to a Roth IRA. Also, married individuals filing separately could not convert to a Roth IRA regardless of their AGI. (Individuals filing MFS who did not live with their spouse at any time during the year were treated as single.) These rules do not apply for conversions from a traditional IRA to a Roth IRA after 2009.

Traditional IRA Rollover Rules Apply

The conversion to a Roth IRA is treated as a rollover, regardless of the conversion method used. Most of the rules for rollovers described in Lesson 7 apply. *Exception:* The one-year waiting period between rollovers does not apply.

Three ways to convert amounts from a traditional IRA to a Roth IRA:

Rollover. The account owner receives a distribution from a traditional IRA and rolls it over (contributes it) to a Roth IRA within 60 days after the distribution. The same property received from the traditional IRA must be rolled over into the Roth IRA. The entire distribution does not have to be rolled over, but the part not rolled over is generally taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% penalty tax on early distributions.

Trustee-to-trustee transfer. Account owners can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.

Same trustee transfer. If the trustee of the traditional IRA also maintains the Roth IRA, the account owner can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA. Conversions of the entire account made with the same trustee can also be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Observation: Regardless of the method used, amounts from a traditional IRA that are transferred into a Roth IRA are often referred to as conversion contributions.

Income from a Conversion

Traditional IRA distributions that would be included in income if they were not converted to a Roth IRA are included in income in the year they are converted from a traditional IRA to a Roth IRA. However, any part of a distribution from a traditional IRA that is a return of basis is not included in income.

2010 conversions. For conversions in 2010, any amount required to be included in income is included in equal amounts in 2011 and 2012. *Exception:* Taxpayers can elect to include the entire amount in income in 2010. This election may not be changed after the due date of the 2010 tax return.

Effect on Substantially Equal Periodic Payment Stream

Account owners who have started taking substantially equal periodic payments from a traditional IRA can convert the traditional IRA to a Roth IRA and continue the periodic payments. The 10% penalty tax on early distributions will not apply even if the distributions are not qualified distributions (as long as they are part of a series of substantially equal periodic payments).

Reporting a Roth IRA Conversion

A conversion from a traditional IRA to a Roth IRA is reported on Form 8606, Part II.

Exception: If the entire conversion is recharacterized, it is not reported on Form 8606.

IRA trustees are required to report to the IRA owner any amounts converted and recharacterized on Form 5498 (which is also furnished to the IRS).

Recharacterizing IRA Contributions and Conversions

It is possible to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution.

Observation: A conversion contribution to a Roth IRA (taxpayer converts a traditional IRA to a Roth IRA) can also be recharacterized. This "undoes" the conversion. Here, the conversion contribution to the Roth IRA is the contribution to the "first IRA" and the transfer of the funds (along with earnings) back to a traditional IRA is the transfer to the "second IRA." The traditional IRA is treated as if it were the original recipient of the contribution, so the individual does not recognize the income that would have been recognized on the Roth conversion.

Recharacterizing to a SEP or SIMPLE IRA. Roth IRA conversion contributions from a SEP IRA or SIMPLE IRA can be recharacterized to a SEP IRA or SIMPLE IRA (including the original SEP IRA or SIMPLE IRA).

Strategy: Recharacterizing a Roth IRA conversion is beneficial if, after the conversion, the Roth IRA's value declines significantly. If the account owner recharacterizes (undoes) the Roth IRA conversion, he will avoid paying taxes on value on the conversion date that no longer exists.

Example: In January 2010, James instructs the trustee of his traditional IRA to transfer $50,000 to a new Roth IRA. James has no basis in his traditional IRA, so this conversion to a Roth IRA results in $50,000 of taxable income in 2010.

James extends the due date for his 2010 tax return until October 17, 2011. In September 2011, the stock market falls and the value of his Roth IRA (that was worth $50,000 when he converted) drops to $30,000. To avoid paying tax on the $20,000 of value he no longer has, James elects to recharacterize his Roth IRA conversion. Using a trustee-to-trustee transfer, he moves the $30,000 in the Roth IRA to a traditional IRA on October 10, 2011. Assuming he has met all the requirements to properly recharacterize the Roth IRA contribution, his Roth IRA conversion is treated as if it never occurred.

How to Recharacterize

To recharacterize an IRA contribution (including a conversion contribution to a Roth IRA) the contribution must be transferred from the first IRA (the one to which the contribution was made) to the second IRA in a trustee-to-trustee transfer.

If the individual properly elects to recharacterize the contribution, it is treated as if it were originally made to the second IRA, instead of to the first IRA. Any earnings transferred from the first IRA to the second IRA are treated as if earned in the second IRA.

Caution: A loss realized while the funds are held in the first IRA cannot be deducted. Instead, the loss is treated as if incurred while held in the second IRA.

Deadline. Generally, the transfer to the second IRA must be made by the due date (including extensions) for the tax return for the year for which the contribution to the first IRA was made.

Requirements. Individuals who recharacterize their contribution must do all three of the following:

1. Instruct the trustee to transfer the contribution, as well as any net income allocable to it, to the second IRA. If there was a loss, the net income transferred may be a negative amount. **Note:** In most cases, the net income allocable to the transfer is determined by the IRA trustee or custodian.
2. Report the recharacterization on their tax return for the year during which the contribution was made.
3. Treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

Example: On June 5, 2010, Bart contributes $2,000 to his traditional IRA (first IRA). On February 28, 2011, he decides that he would prefer to contribute to a Roth IRA. He instructs the trustee of the first IRA to transfer (trustee-to-trustee) the $2,000 contribution plus attributable net income to the trustee of a Roth IRA (second IRA). Bart notifies the trustees of both IRAs that he is recharacterizing his $2,000 contribution for 2010. The transfer is completed on March 2, 2011. On his 2010 tax return, Bart treats the $2,000 as having been contributed to a Roth IRA.

Variation: Same facts, except that the $2,000 contribution is initially made to a Roth IRA and the recharacterizing transfer is made to a traditional IRA. On Bart's 2010 tax return, he treats the $2,000 as having been contributed to a traditional IRA.

Example: On April 1, 2010, when her Roth IRA is worth $80,000, Allison makes a $160,000 conversion contribution to the Roth IRA. On March 25, 2011, Allison requests that the $160,000 be recharacterized to a traditional IRA. On April 1, 2011, the date the Roth IRA trustee transfers the contribution to a traditional IRA, the Roth IRA is worth $225,000.

No other contributions have been made to the Roth IRA and no distributions have been taken. The adjusted opening balance (for computing income attributable to the $160,000 conversion contribution) is $240,000 ($80,000 + $160,000). The adjusted closing balance is $225,000. Thus, the net income allocable to the $160,000 contribution is a $10,000 loss {$160,000 × [($225,000 – $240,000) ÷ $240,000]}. So, to recharacterize the $160,000 conversion contribution that occurred on April 1, 2010, the Roth IRA trustee must transfer $150,000 ($160,000 – $10,000) from Allison's Roth IRA to her traditional IRA.

Notifying the IRA Trustees

To recharacterize a contribution, individuals must notify both the trustee of the first IRA (the one to which the contribution was actually made) and the trustee of the second IRA (the one to which the contribution is being moved) that they have elected to treat the contribution as having been made to the second IRA rather than the first. The notifications must be made by the date of the transfer. Only one notification is required if both IRAs are maintained by the same trustee. The notifications must include all of the following information:

- The type and amount of the contribution to the first IRA that is to be recharacterized.
- The date on which the contribution was made to the first IRA and the year for which it was made.

- A direction to the trustee of the first IRA to transfer in a trustee-to-trustee transfer the amount of the contribution and any net income (or loss) allocable to the contribution to the trustee of the second IRA.
- The name of the trustee of the first IRA and the name of the trustee of the second IRA.
- Any additional information needed to make the transfer.

Additional Rules

No deduction allowed. The contribution to the first IRA cannot be deducted. Any net income transferred with the recharacterized contribution is treated as earned in the second IRA. The contribution will not be treated as having been made to the second IRA to the extent any deduction was allowed for the contribution to the first IRA.

Election to recharacterize cannot be changed. After the transfer to the second IRA has taken place, the election to recharacterize cannot be changed.

Year conversion is made. For recharacterization purposes, individuals who receive a traditional IRA distribution in one tax year and roll it over into a Roth IRA in the following year (but still within the 60-day rollover period) treat the contribution to the Roth IRA as if it were made in the earlier tax year.

Same trustee. Recharacterizations made with the same trustee can be made by redesignating the first IRA as the second IRA, rather than transferring the account balance.

More than one IRA. Individuals with more than one IRA figure the amount to be recharacterized based only on the account from which they withdraw the contribution.

Recharacterizing excess contributions. Only actual contributions can be recharacterized. Excess contributions for prior years that are being applied to current year contributions can be recharacterized only if the recharacterization would still be timely with respect to the tax year for which the applied contributions were actually made.

No recharacterizing employer contributions. Employer contributions (including elective deferrals) to a SEP or SIMPLE plan cannot be recharacterized as contributions to another IRA.

Recharacterization not counted as rollover. The recharacterization of a contribution is not treated as a rollover for the one-year 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.

Deceased IRA owners. The election to recharacterize can be made on behalf of a deceased IRA owner by the executor, administrator or other person responsible for filing the decedent's final income tax return.

Effect of previous tax-free transfers. An amount moved from one IRA to another in a tax-free transfer (such as a rollover) generally cannot be recharacterized. *Exception:* Individuals who mistakenly roll over or transfer an amount from a traditional IRA to a SIMPLE IRA can recharacterize the amount as a contribution to another traditional IRA.

Note: A conversion or rollover to a Roth IRA is not a tax-free transfer (since the amount converted in excess of the taxpayer's basis is included in income). So a conversion contribution to a Roth IRA can be recharacterized.

Reconverting to a Roth IRA

Individuals cannot convert and reconvert an amount to a Roth IRA during the same tax year or, if later, during the 30-day period starting on the date of recharacterization. A reconversion during either of these periods is a failed conversion.

Extension of Time to Recharacterize

Ordinarily, individuals must recharacterize IRA contributions by the extended due date of the return for the year the contribution to the first IRA was made. But individuals who miss this deadline can still recharacterize a contribution if:

- Their return was timely filed for the year the election to recharacterize should have been made and
- They take appropriate corrective action within six months from the due date of their return, excluding extensions. For returns due April 15, 2011, this period ends on October 15, 2011. If the deadline for taking corrective action falls on a Saturday, Sunday or legal holiday, the due date is delayed until the next business day.

Appropriate corrective action consists of (1) notifying the trustees of the individual's intent to recharacterize, (2) providing the trustee with all necessary information and (3) having the trustee transfer the contribution.

Once this is done, the individual must amend his return to show the recharacterization. The regular due date for filing an amended return applies. Report the recharacterization on the amended return and write "Filed pursuant to Section 301.9100-2" on top of the return.

Reporting a Recharacterization

Individuals who elect to recharacterize a contribution to one kind of IRA (Roth or non-Roth) as a contribution to another type of IRA must report the recharacterization on their tax return as directed by Form 8606 and its instructions. To the extent a contribution is recharacterized, it is treated on the return as having been made to the second IRA. In addition, a statement that explains the recharacterization must be attached to the return for the year for which the original contribution was made.

If the recharacterization occurs in the year after the conversion, the account owner should receive a Form 1099-R for the later year, stating that he made a recharacterization of an amount converted in the prior year.

Roth IRA Conversion Is Recharacterized

If an individual converts a non-Roth IRA to a Roth IRA and later recharacterizes only part of the amount converted, the amount not recharacterized (the part left in the Roth IRA) is reported on Form 8606, Part II. If the entire amount is recharacterized, none of the recharacterization is reported on Form 8606.

The amount converted from the non-Roth IRA is included in the IRA distributions reported on Form 1040. If the recharacterization occurs in the same year as the conversion, also include the amount transferred back from the Roth IRA on that line. If the recharacterization occurs in the year after the conversion, report the amount transferred back to the Roth IRA only in the attached statement.

Note: If the recharacterization occurs in the year after the contribution, the recharacterized amount is not reported on the face of the tax return for either year (the year of conversion or the year the conversion contribution is recharacterized).

Example: Tracy converted $20,000 from a traditional IRA to a new Roth IRA on May 20, 2010. On April 7, 2011, the value of that Roth IRA had fallen to $19,000. Rather than pay tax on the $20,000 of income generated by the May 20, 2010 conversion, Tracy decides to recharacterize the conversion by transferring the $19,000 to a traditional IRA in a trustee-to-trustee transfer, which occurs on April 8, 2011. Tracy reports the $20,000 on the line for "IRA distributions" on her 2010 return. She attaches a statement to that return indicating that:

1. She made a conversion of $20,000 from a traditional IRA on May 20, 2010.
2. She recharacterized the entire amount, which was then valued at $19,000, back to a traditional IRA on April 8, 2011.

Tracy does not report the $19,000 transfer on page one of her 2010 or 2011 returns. It is reported only on the statement included with her 2010 return.

Traditional IRA Contribution Is Recharacterized

If only part of the contribution is recharacterized, report the nondeductible portion (if any) of the remaining traditional IRA contribution on Form 8606, Part I. If the entire contribution is recharacterized, none of it is reported on Form 8606.

If the recharacterization occurs in the same year as the traditional IRA contribution, include the amount transferred from the traditional IRA to the Roth IRA in the total IRA distributions reported on Form 1040. If the recharacterization occurs in the year after the contributions, report the amount transferred only in the attached statement.

Example: Juliana is single and covered by a retirement plan. She contributed $4,000 to a new traditional IRA on May 27, 2010. On February 24, 2011, she determines that her 2010 modified AGI will limit her traditional IRA deduction to $1,000. Her traditional IRA is worth $4,400 on that date. She decides to recharacterize $3,000 of the traditional IRA contribution as a Roth IRA contribution. To accomplish this, she has $3,300 ($3,000 contribution plus $300 related earnings) transferred from her traditional IRA to a Roth IRA in a trustee-to-trustee transfer. She deducts the $1,000 traditional IRA contribution on her 2010 Form 1040. She is not required to file Form 8606, but she must attach a statement to her return that indicates:

1. She contributed $4,000 to a traditional IRA on May 27, 2010.
2. She recharacterized $3,000 of that contribution on February 24, 2011, by transferring $3,000 plus $300 of related earnings from her traditional IRA to a Roth IRA in a trustee-to-trustee transfer.
3. The entire $1,000 of the remaining traditional IRA contribution is deducted on Form 1040.

Juliana does not report the $3,300 distribution from her traditional IRA on her 2010 Form 1040 because the distribution occurred in 2011. She does not report the distribution on her 2011 Form 1040 because the recharacterization related to 2010 and was explained in an attachment to her 2010 return.

Roth IRA Contribution Is Recharacterized

Report the nondeductible portion (if any) of the contribution that is recharacterized as a traditional IRA contribution on Form 8606, Part I. If the entire contribution is not recharacterized, do not report the portion of the contribution remaining in the Roth IRA on Form 8606.

If the recharacterization occurs in the same year as the contribution, include the amount transferred from the Roth IRA in total IRA distributions reported on Form 1040. If the recharacterization occurs in the year after the contribution, report the amount transferred only in the attached statement and not on the face of either tax return.

Example: Kelsey is single. She contributed $4,000 to a new Roth IRA on June 16, 2010. On December 29, 2010, she determines that her 2010 modified AGI will allow her to fully deduct a traditional IRA contribution. She decides to recharacterize the Roth IRA contribution as a traditional IRA contribution. She has the $4,200 Roth IRA balance ($4,000 contribution plus $200 related earnings) transferred from her Roth IRA to a traditional IRA in a trustee-to-trustee transfer on that date. Kelsey deducts the $4,000 traditional IRA contribution on her 2010 tax return. She is not required to file Form 8606, but must attach a statement to her return that indicates that:

1. She contributed $4,000 to a new Roth IRA on June 16, 2010.
2. She recharacterized that contribution on December 29, 2010 by transferring $4,200, the balance in the Roth IRA, to a traditional IRA in a trustee-to-trustee transfer.
3. $4,000 of the traditional IRA contribution is deducted on her 2010 return.

She includes the $4,200 distribution from the Roth IRA on the line for “IRA Distributions” for 2010. If that is her only IRA distribution for the year, the taxable amount of her IRA distributions will be zero.

Rollovers from an Employer Plan to a Roth IRA

All or part of an eligible rollover distribution from the following plans can be rolled over into a Roth IRA:

Qualified pension, profit-sharing or stock bonus plan [including a 401(k) plan].

- 403(a) plan.
- 403(b) annuity.
- 457 plan.

Observation: Eligible rollover distributions from the above plans made to the deceased participant’s spouse can also be rolled over to a Roth IRA.

Any amount rolled over is subject to the same rules for converting a traditional IRA into a Roth IRA. Also, the rollover contribution must meet the rollover requirements that apply to the specific type of retirement plan.

Income from the Rollover

Distributions from an employer retirement plan that would have been included in income if they were not rolled over into a Roth IRA are included in gross income. This means that any part of an employer plan distribution that is a return of after-tax contributions is tax-free. Also, the distributions rolled into a Roth IRA are not subject to the 10% penalty tax on early distributions.

Special rules apply to the income triggered by converting a traditional IRA to a Roth IRA in 2010. These rules also apply to the rollover of funds from an employer plan to a Roth IRA in 2010.

Rollover Methods

Plan participants can roll over amounts from an employer retirement plan to a Roth IRA in one of the following ways:

Rollover. The participant receives a distribution from an employer retirement plan and rolls it over (contributes it) to a Roth IRA within 60 days after the distribution. Since the distribution is paid directly to the participant, the payer generally must withhold 20% of it.

Direct rollover option. A qualified plan must give participants the option of having any part of an eligible rollover distribution paid directly to a Roth IRA. Generally, no tax is withheld from any part of the designated distribution that is directly paid to the trustee of the Roth IRA.

Reporting the Rollover to a Roth IRA

A rollover to a Roth IRA is not a tax-free distribution (other than the portion attributable to after-tax contributions made to the employer plan). A rollover from an employer retirement plan to a Roth IRA must be reported on Form 1040. The distribution is shown in box 1 of Form 1099-R. After-tax contributions made to the plan are usually shown in box 5 of Form 1099-R. These are subtracted to get the taxable amount of the rollover.

Unlike a conversion of a traditional IRA to a Roth IRA, rollovers from employer plans to Roth IRAs generally are not reported on Form 8606. *Exception:* For 2010, a rollover from an employer plan to a Roth IRA will be reported on Form 8606.

Rollovers from a Roth IRA

Individuals can withdraw, tax-free, all or part of the assets from one Roth IRA if they contribute them within 60 days to another Roth IRA. Most of the rules for rollovers described in Tab 8 apply to these rollovers. However, rollovers from retirement plans other than Roth IRAs are disregarded for purposes of the one-year waiting period between rollovers.

A rollover from a designated Roth account can only be made to another designated Roth account or to a Roth IRA.

Failed Conversions and Rollovers

Converting a traditional, SEP or SIMPLE IRA into a Roth IRA or rolling employer retirement plan distributions into a Roth IRA before 2010 is a failed conversion or failed rollover if the taxpayer's modified AGI for that year was over $100,000 or he filed MFS.

Note: For tax years starting in 2010, the $100,000 modified AGI limit on conversions and rollovers is eliminated and married taxpayers filing a separate return can convert or rollover amounts to a Roth IRA. However, a failed 2009 conversion or rollover can still be corrected through October 15, 2010.

Results of Failed Conversions and Rollovers

If the contribution to the Roth IRA is not timely recharacterized, the contribution is treated as a regular contribution to the Roth IRA and subject to the following tax consequences:

A 6% excise tax per year applies to any excess contribution not withdrawn from the Roth IRA.

The distribution from the traditional IRA or employer retirement plan is included in income and may be subject to the 10% penalty tax on early distributions if the individual is under age 59½.

Roth IRA Distributions

Qualified distributions or distributions that are a return of regular Roth IRA contributions are not taxable. Roth IRA distributions that are rolled over tax-free into another Roth IRA are also excluded from income. A part of other distributions may be included in income.

Qualified Distributions

Qualified distributions are not included in taxable income. A qualified distribution is any Roth IRA distribution that meets both the following requirements:

1. It is made after the five-tax-year period beginning with the first tax year for which a contribution was made to a Roth IRA set up for the individual's benefit.
2. The distribution is one of the following:
   a) Made on or after the date the account owner reaches age 59½.
   b) Made because the account owner is disabled.
   c) Made to a beneficiary or to the account owner's estate after his death.
   d) Meets the requirements for the first-time homebuyer exception to the 10% penalty tax on early IRA distributions.

One five-year period for determining qualified distributions. Each taxpayer has only one five-tax-year period for all Roth IRAs owned. It begins with the earliest of:

- The first day of the individual's tax year for which the first regular contribution is made to any Roth IRA for him.
- The first day of the individual's tax year in which the first conversion contribution is made to any Roth IRA for him.

- The first day of the tax year in which a rollover contribution from a designated Roth account is made to any Roth IRA established for the individual.

Observation: If an individual distributes the entire balance of his Roth IRA and later makes additional contributions, the five-tax-year period does not start over.

Caution: Individuals who convert a traditional, SEP or SIMPLE IRA to a Roth IRA (or roll an employer plan distribution into a Roth IRA) may be subject to the 10% penalty tax on early distributions when a qualified distribution is received, even though the qualified distribution is not subject to income tax.

Nonqualified Distributions

Nonqualified Roth IRA distributions are taxable income to the extent the distribution, when added to all previous Roth IRA distributions, exceeds the owner's Roth IRA contributions.

Ordering rules. Contributions (including conversion contributions and rollover contributions from employer plans) and earnings are considered to be distributed from a Roth IRA in the following order:

1. Regular contributions.
2. Taxable portion (amount required to be included in gross income because of the conversion or rollover) of conversion and rollover contributions (first-in, first-out).
3. Nontaxable portion of conversion and rollover contributions (first-in, first-out).
4. Earnings on contributions.

Rollover contributions from other Roth IRAs are disregarded for this purpose.

Observation: This favorable ordering rule, which lets account owners withdraw all their contributions to a Roth IRA tax-free (before any earnings) is a significant difference between traditional and Roth IRAs. For traditional IRAs, only a portion of the owner's basis is allocated to each distribution, so any basis is not fully recovered until the final distribution.

10% Penalty Tax on Early Distributions

Distributions after a conversion or rollover. A Roth IRA distribution taken within a certain time after an individual makes a conversion or rollover contribution to a Roth IRA may be subject to the 10% penalty tax on early distributions. This rule applies to distributions taken during the five-year period starting on the first day of the year in which the conversion or rollover occurs.

Generally, the 10% tax is due on any amount attributable to the taxable portion of the amount converted or rolled over (the conversion or rollover contribution). A separate five-year period applies to each conversion and rollover.

Caution: The five-year period for determining whether the 10% early distribution tax applies to a distribution from a conversion or rollover contribution is determined separately for each conversion and rollover, and is not necessarily the same as the five-year period used for determining whether a distribution is a qualified distribution.

Example: Jim has no Roth IRAs until he converts his traditional IRA to a Roth IRA on February 25, 2010. On that day, he also makes a regular contribution to the Roth IRA for 2009. The five-year period for the conversion begins January 1, 2010, while the five-year period for determining whether future Roth IRA distributions are qualified distributions begins on January 1, 2009.

Observation: The 10% penalty tax applies even if the conversion or rollover contribution is not subject to income tax in the year distributed. The penalty tax also applies to any portion of the distribution attributable to earnings on contributions.

Nonqualified distributions. Unless one of the "regular" exceptions applies, the 10% penalty tax applies to the taxable part of any distribution that is not a qualified distribution.

Example: When Hannah died in 2010, her Roth IRA (opened with a contribution on June 1, 2006) contained regular (nonconversion) contributions of $4,000 and earnings of $1,000. Her four children are equal beneficiaries of the Roth IRA. If each child receives $1,250 ($5,000 ÷ 4) in 2010, $1,000 ($4,000 ÷ 4) is treated as coming from regular contributions and $250 ($1,000 ÷ 4) from earnings.

Because the distributions are made before the end of the five-year period starting on January 1 of the year a Roth IRA contribution was first made for Hannah (1/1/06), it is a nonqualifying distribution. Each beneficiary includes $250 in income for 2010. The 10% penalty tax on early distributions does not apply because the distribution was made as a result of the account owner's death.

Variation: If the children waited until 2011 to receive their distributions, the five-year period would have been met and the distributions would have been free of income tax as well as penalty-free.

Required Minimum Distribution Rules for Roth IRAs

Account owners are not required to take distributions from their Roth IRA at any age. The required minimum distribution (RMD) rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the account owner dies, the RMD rules that apply to traditional IRAs apply to Roth IRAs as though the Roth IRA owner died before his required beginning date (RBD).

Generally, under these RMD rules, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year the owner dies. However, if all beneficiaries are designated beneficiaries, the interest can be distributed over the oldest beneficiary's life expectancy, as long as distributions begin before the end of the calendar year following the year of death.

Exception: If the Roth IRA's sole beneficiary is the decedent's surviving spouse, the spouse can either:

- Delay distributions until the decedent would have turned age 70½.
- Treat the Roth IRA as his own (in which case RMDs from the Roth IRA would not have to begin until after the spouse's death).

If the RMDs are not taken, a 50% penalty tax applies.

Decedents With Traditional and Roth IRAs

Generally, if an account owner has multiple IRAs with the same beneficiary, the total RMD for all those IRAs can be taken from any one or more of his IRAs. However, a Roth IRA cannot be used to satisfy RMDs for a traditional or SIMPLE IRA. Likewise, distributions from traditional or SIMPLE IRAs cannot be made to satisfy the RMD for Roth IRAs.

Combining Roth IRAs for the RMD

An individual can satisfy the RMD requirement for one Roth IRA by taking a distribution from another Roth IRA only if he inherited both Roth IRAs from the same decedent.

Recognizing Losses on Investments

A loss on a Roth IRA investment can be recognized on the account owner's tax return only when all the amounts in all of his Roth IRA accounts have been distributed and the total distributions are less than his unrecovered basis. *Basis* is generally the total amount of contributions in the Roth IRAs.

The loss is a miscellaneous itemized deduction, subject to the 2%-of-AGI limit. Note that any such losses are added back to taxable income for calculating alternative minimum tax.

Example: Kim established a Roth IRA in 2004, and has made an annual contribution each year, bringing her total basis in the account to $20,000. On January 1, 2010, when the value of her Roth IRA is $17,000, Kim withdraws the entire $17,000. She recognizes a $3,000 ($20,000 – $17,000) loss as a miscellaneous itemized deduction (subject to 2%-of-AGI) on her 2010 return because her unrecovered basis exceeds FMV of her account, and she took full distribution of the account.

Variation: Assume the same facts except Kim decided to roll over the balance of her Roth IRA to a new Roth IRA at a different financial institution. No loss is allowed, even though the entire balance in the first Roth IRA is distributed, because Kim will still have funds in a Roth IRA (the new Roth IRA) at the end of the year.

Excess Contributions

A 6% excise tax applies to any excess contribution to a Roth IRA. Excess contributions are contributions to an individual's Roth IRAs for a year that equal the total of:

1. Roth IRA contributions for the year (other than rollovers from a Roth IRA or employer plan or conversion contributions from a traditional IRA) in excess of the contribution limit for the year, plus
2. Any excess contributions for the preceding year, reduced by the total of:
   a) Roth IRA distributions for the year.
   b) The excess of the contribution limit for the year over all IRA contributions for the year.
   c) Withdrawal of excess contributions.

For determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing the tax return for the year is treated as an amount not

contributed, provided any earnings on the contributions are also withdrawn. The earnings are considered earned and received in the year the excess contribution was made.

Applying Excess Contributions to a Later Tax Year

If contributions to a Roth IRA for a year were more than the limit, the account owner can apply the excess contribution to a later (but not an earlier) year if the contributions for that later year are less than the contribution limit for that year. However, the account owner may still be subject to the 6% excess contributions penalty tax for any year the excess contribution remains in the account at year-end.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Melanie utilizes The Harman Group to manage both her traditional IRA and Roth IRA accounts. Melanie instructs the group to move $5,000 from her traditional IRA account to her Roth IRA account in July. What type of conversion has Melanie employed in moving funds in her accounts?

   a. Same trustee transfer.

   b. Rollover.

   c. Trustee-to-trustee transfer.

5. Jason recharacterizes a Roth IRA contribution in the same year that the contribution was initially made. Jason chooses to recharacterize the entire contribution, not just a portion of it, to a traditional IRA. How would Jason report the recharacterization at the end of the year?

   a. Jason should report the amount on an attached statement and not on the face of the tax return.

   b. The contribution that is recharacterized should be reported on Form 8606, Part I by Jason.

   c. Jason should report the entire amount on Form 1040 at the end of the year.

   d. Jason should report the recharacterization on Form 8606, Part II at the end of the year.

6. Which of the following is true regarding qualified distributions for a Roth IRA?

   a. All qualified distributions from a Roth IRA are included in taxable income.

   b. Rolled over Roth IRA distributions to another Roth IRA are taxable to the account owner.

   c. A qualified distribution is made on or after the account owner reaches the age of 70½.

   d. A distribution made to an account owner’s estate after death meets the criteria of a qualified distribution if made within the five-year-tax period.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. Melanie utilizes The Harman Group to manage both her traditional IRA and Roth IRA accounts. Melanie instructs the group to move $5,000 from her traditional IRA account to her Roth IRA account in July. What type of conversion has Melanie employed in moving funds in her accounts? **(Page 22)**

   a. Same trustee transfer. [This answer is correct. If the trustee of a traditional IRA also maintains an individual's Roth IRA, the account owner can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA according to the IRS Reg. 1.4808A-4. This is what Melanie has instructed The Harman Group to do in her account. Conversions of the entire account made with the same trustee can also be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.]

   b. Rollover. [This answer is incorrect. If an account owner receives a distribution from a traditional IRA and rolls it over (contributes it) to a Roth IRA within 60 days after the distribution, this is considered a rollover. Melanie did not receive a contribution from her traditional IRA account and recontribute the amount to her Roth IRA account.]

   c. Trustee-to-trustee transfer. [This answer is incorrect. Account owners can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA. Melanie did not make this type of conversion because both of her IRA accounts are held by the same trustee.]

5. Jason recharacterizes a Roth IRA contribution in the same year that the contribution was initially made. Jason chooses to recharacterize the entire contribution, not just a portion of it, to a traditional IRA. How would Jason report the recharacterization at the end of the year? (**Page 28)**

   a. Jason should report the amount on an attached statement and not on the face of the tax return. [This answer is incorrect. If the Roth IRA recharacterization occurs in the year *after* the contribution, the taxpayer should report the amount transferred in a statement attached to the tax return and not on the face of either year's tax return. In this scenario, Jason recharacterized the amount in the same year that the contribution was initially made.]

   b. The contribution that is recharacterized should be reported on Form 8606, Part I by Jason. [This answer is incorrect. If a portion of a traditional IRA contribution, not a Roth IRA, is recharacterized, the taxpayer should report the nondeductible portion (if any) of the remaining traditional IRA contribution on Form 8606, Part I. Jason also recharacterized the entire contribution, rather than just a portion of the contribution.]

   c. Jason should report the entire amount on Form 1040 at the end of the year. [This answer is correct. If a Roth IRA contribution is recharacterized and the recharacterization occurs in the same year as the original contribution, the amount transferred from the Roth IRA should be reported in total IRA distributions on Form 1040 by the taxpayer according to the IRS.]

d. Jason should report the recharacterization on Form 8606, Part II at the end of the year. [This answer is incorrect. If an individual converts a non-Roth IRA to a Roth IRA and later recharaterizes only part of the amount converted, the amount not recharacterized (the part left in the Roth IRA) is reported on Form 8606, Part II. Jason does not convert from a non-Roth IRA to a Roth IRA.]

6. Which of the following is true regarding qualified distributions for a Roth IRA? **(Page 30)**

   a. All qualified distributions from a Roth IRA are included in taxable income. [This answer is incorrect. Qualified distributions are not included in taxable income according to the IRS. Nonqualified Roth IRA distributions are taxable income to the extent of the distribution, when added to all previous Roth IRA distributions.]

   b. Rolled over Roth IRA distributions to another Roth IRA are taxable to the account owner. [This answer is incorrect. Roth IRS distributions that are rolled over tax-free into another Roth IRA are excluded from income for the account owner for the year, according to the IRS.]

   c. A qualified distribution is made on or after the account owner reaches the age of 70½. [This answer is incorrect. A requirement of a qualified distribution according to IRC Section 408A(d)(1) is the distribution must be made on or after the date that the account owner reaches age 59½.]

   d. A distribution made to an account owner's estate after death meets the criteria of a qualified distribution if made within the five-year-tax period. [This answer is correct. A qualified distribution can be a Roth IRA distribution that meets both of the following requirements: (1) it is made after the five-tax-year period beginning with the first tax year for which a contribution was made to a Roth IRA set up for the individual's benefit, and (2) made to a beneficiary or to the account owner's estate after his death.]

EXAMINATION FOR CPE CREDIT

Lesson 2

Determine the best answer for each question below. Then log on to our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

4. Which of the following is an advantage of a Roth IRA over a traditional IRA?

   a. No distributions from a Roth IRA are taxable to the individual receiving them.

   b. Individuals can contribute to a Roth IRA after age 70½.

   c. All contributions to a Roth IRA are deductible in the year contributed.

   d. A portion of the total basis in the Roth IRA is allocated to each distribution.

5. On May 1, 2010, Shelia decides to contribute $3,000 to a traditional IRA. On January 1, 2011, Shelia decides she would rather the entire contribution be to a Roth IRA and instructs her trustee to recharacterize the contribution. This is completed on January 20, 2011. Which of the following is true about Shelia's contribution?

   a. Shelia's contribution will be treated as a $3,000 contribution to a traditional IRA in 2010.

   b. Shelia's contribution will be treated as a $3,000 contribution to a Roth IRA in 2011.

   c. Shelia's contribution will be treated as a $3,000 contribution to a Roth IRA in 2010.

   d. Shelia's contributions will cancel each other out since one was $3,000 in 2010 and the other was $3,000 in 2011.

6. If an individual rolls over an amount from an employer plan to a Roth IRA, which of the following is correct?

   a. Rollovers from an employer plan to a Roth IRA should be reported on Form 8606 in 2010.

   b. All distributions from an employer plan that are rolled over to a Roth IRA are excluded from gross income.

   c. Participants must receive employer contributions in their employer plan before they can be rolled over to a Roth IRA.

   d. Rolled over distributions would be subject to a 10% penalty tax due to early distribution from the employer plan.

Lesson 3: SIMPLE IRA Plans

Learning Objectives

Completion of this lesson will enable you to:

- Describe the various aspects of SIMPLE IRA plans, benefits, and requirements.

What Is a SIMPLE IRA Plan?

A SIMPLE IRA plan is a written salary reduction arrangement under which eligible employees can elect to have the employer make contributions to a SIMPLE IRA rather than receiving that amount in cash. Under the plan, employees can elect to defer a portion of their compensation and employers are required to either match the deferral or make a contribution on behalf of each employee all subject to certain limits.

A SIMPLE plan can also be adopted as part of a 401(k) plan.

Note: The term *SIMPLE* is an acronym for *Savings Incentive Match Plan for Employees*. Beginning in 1997, SIMPLE IRA plans replaced salary reduction SEPs (SARSEPs). Accordingly, new SARSEPs cannot be established after 1996. However, employers can continue to maintain SARSEPs established before 1997 (including allowing new employees hired after 1996 to participate in the plan).

Observation: A SIMPLE IRA plan is not a qualified plan and therefore, is not subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. A SIMPLE plan adopted as part of a 401(k) plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules; however, the other 401(k) qualified plan rules continue to apply.

Who Can Set Up a SIMPLE IRA Plan?

Businesses that meet both of the following requirements can set up a SIMPLE IRA plan:

- Has 100 or fewer employees.
- Does not maintain another qualified plan unless the other plan is for collective bargaining employees.

All types of business entities—corporations, S corporations, partnerships, LLCs and sole proprietorships—are eligible to set up a SIMPLE IRA plan, provided the above requirements are met. Tax-exempt employers and governmental entities can also set up SIMPLE IRA plans.

SIMPLE IRA plans must be established by the employer, not the employee. Similar to a SEP, the SIMPLE IRA plan for a partnership or sole proprietorship should be established in the name of the partnership or sole proprietorship.

Employee Limit

A business can set up a SIMPLE IRA plan only if it had 100 or fewer employees who received $5,000 or more in compensation from the business for the preceding year.

A business must take into account all full-time, part-time and seasonal employees employed at any time during the calendar year regardless of whether they are eligible to participate. Thus, the following employees must be taken into account:

- Employees covered by a collective-bargaining agreement and nonresident aliens, even if such employees are excluded from participating in the plan.
- Employees who have not met the plan's minimum participation requirements.

Employees also include leased employees and self-employed individuals who received earned income from the employer during the year (Notice 98-4). These employees generally must be eligible to participate on the same basis as other employees.

Once a business sets up a SIMPLE IRA plan, it must continue to meet the 100-employee limit each year it maintains the plan.

Related employers. As with other employer retirement plans, the term *employee* includes employees of related organizations under Section 414(b), (c) and (m). Thus, an employer is eligible to establish a SIMPLE IRA plan only if that employer and all related entities satisfy the requirements on an aggregate basis.

Observation: Because of this aggregation rule, a business that has never had more than 100 employees nevertheless may be ineligible to establish a SIMPLE IRA plan.

Example: Paula is a sole proprietor of two businesses: Computers-R-Us, a computer rental agency that had 80 employees who were paid more than $5,000 in 2009; and We-Fix-It, a computer repair business that had 60 employees who were paid more than $5,000 in 2009. Can either of these two businesses establish a SIMPLE IRA plan for 2010?

No. The employees of businesses that are under common control are treated as employees of a single employer. Thus, for purposes of the SIMPLE IRA plan rules, all 140 employees are treated as employed by Paula. Therefore, neither Computers-R-Us nor We-Fix-It is eligible to establish a SIMPLE IRA plan for 2010.

Grace period when business no longer meets 100-employee limit. If a business maintains a SIMPLE IRA plan for at least one year and ceases to meet the 100-employee limit in a later year, it will be treated as meeting it for the two calendar years immediately following the calendar year for which it last met it.

A different rule applies if the business fails to meet the 100-employee limit because of an acquisition, disposition or similar transaction. Under this rule, the SIMPLE IRA plan will be treated as meeting the 100-employee limit for the year of the transaction and the two following years if both of the following conditions are satisfied:

1. Coverage under the plan has not significantly changed during the grace period.
2. The SIMPLE IRA plan would have continued to qualify after the transaction if the business had remained a separate employer.

Caution: The grace period for acquisitions, dispositions and similar transactions also applies if, because of these types of transactions, the business does not meet the rules explained below under *Other Qualified Plan* or *Who Can Participate in a SIMPLE IRA Plan?*

Other Qualified Plan

The SIMPLE IRA plan generally must be the only retirement plan to which the business makes contributions, or to which benefits accrue, for service in any year beginning with the year the SIMPLE IRA plan becomes effective [IRC §408(p)(2)(D)]. *Exception:* A business that maintains a qualified plan for collective bargaining employees is permitted to maintain a SIMPLE IRA plan for other employees.

Calendar Year Requirement

SIMPLE IRA plans must be maintained on a calendar-year basis. Accordingly, employer eligibility is determined on a calendar-year basis.

Who Can Participate in a SIMPLE IRA Plan?

Eligible Employee

Any employee is eligible to participate if he:

- Received at least $5,000 in compensation from the business during any two years preceding the current calendar year (whether or not consecutive) and
- Is reasonably expected to receive at least $5,000 in compensation during the current calendar year.

The term *employee* includes a self-employed individual who received earned income.

Note: The business can provide more liberal participation requirements than these, but not more restrictive ones. For example, an employer could allow employees to begin participating as soon as they are employed.

The commonly controlled group and affiliated service group rules of Sections 414(b), (c) and (m) apply in determining who is an employee. Thus, for example, if two related businesses must be aggregated under Section 414(b), all employees of either business who satisfy the eligibility requirements must be allowed to participate in the plan.

Observation: Employees who meet the participation requirements must be eligible to participate in the plan even if they also participate in another retirement plan sponsored by a different unrelated employer for the same year. However, the employee's salary reduction contributions may be limited.

Excludable Employees

The following employees do not need to be covered under a SIMPLE IRA plan:

- Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the business.
- Nonresident alien employees who have received no U.S.-source wages, salaries or other personal services compensation from the business.

Compensation

Employee. Compensation for an employee is:

- Total wages, tips and other compensation from the employer subject to federal income tax withholding and the amounts paid for domestic service in a private home, local college club or local chapter of a college fraternity or sorority, *plus*
- The employee's salary reduction contributions made under the SIMPLE IRA plan and, if applicable, elective deferrals under a Section 401(k) plan, a SARSEP or a Section 403(b) annuity contract and compensation deferred under a Section 457 plan required to be reported by the employer on Form W-2.

Self-employed. For a self-employed person, compensation means net earnings from self-employment determined under Section 1402(a), prior to subtracting any contributions made under the SIMPLE IRA plan on behalf of the self-employed person. In Publication 590, the IRS defines this as net earnings from self-employment [line 4, Section A, or line 6, Section B, of Schedule SE (Form 1040)] before subtracting any contributions made to the SIMPLE IRA plan for the self-employed person.

Contributions to a SIMPLE IRA Plan

Contributions are made up of employees' salary reduction contributions and employer contributions. The employer must make either matching contributions or nonelective contributions. No other contributions can be made to the SIMPLE IRA plan.

Employee Contributions

Salary reduction contributions. The amount the employee chooses to have the employer withhold from his salary and contribute to a SIMPLE IRA on his behalf cannot be more than $11,500 for 2010. These contributions must be expressed as a percentage of the employee's compensation unless the employer permits employees to express them as a specific dollar amount. The employer cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the $11,500 limit.

Catch-up contributions. A SIMPLE IRA plan can permit participants who are age 50 or older at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2010 for SIMPLE IRA plans is $2,500.

Salary reduction contributions are not treated as catch-up contributions for 2010 until they exceed $11,500. However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts:

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

Employee Salary Reduction Contribution Limits (2010)		
	Under age 50	Age 50 or older
Regular limit	$ 11,500	$ 11,500
Catch-up contribution limit	–	2,500
Maximum contribution	$ 11,500	$ 14,000

Employer Contributions

An employer has two choices in determining its contributions to the SIMPLE IRA plan:

1. A 2% nonelective employer contribution, where employees eligible to participate (that is, have at least $5,000 of compensation for the year, or a lesser amount if the employer chooses) receive an employer contribution equal to 2% of their compensation (limited to $245,000 in 2010), regardless of whether they make their own contributions.
2. A dollar-for-dollar match up to 3% of compensation, where only the participating employees who have elected to make contributions will receive an employer contribution (that is, the matching contribution).

Note: If the employer chooses a matching contribution less than 3%, the percentage must be at least 1%. The employer must notify its employees of the lower match within a reasonable period of time before the 60-day election period for the calendar year. The employer cannot choose a percentage less than 3% for more than two years during the five-year period that ends with (and includes) the year for which the choice is effective.

Each year, the employer can choose which method it will use for the next year's contributions. This choice is part of the information the business is required to communicate to employees before the beginning of the 60-day election period.

Time Limits for Contributing Funds	
Employee's salary reduction contributions	**Employer's matching or nonelective contributions**
Within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash.	No later than the due date (including extensions) for filing the employer's federal income tax return for the year.
Caution: The Department of Labor (DOL) has indicated that most SIMPLE IRA plans are also subject to Title I of ERISA so salary reduction contributions to these plans must be made to the SIMPLE IRA as of the earliest date on which the contributions can reasonably be segregated from the employer's general assets, but in no event later than the 30-day deadline described above. Final DOL regulations issued in 2010 provide a safe harbor for small plans with fewer than 100 participants whereby an employer that deposits employee deferrals under a SIMPLE IRA to the employee's SIMPLE IRA no later than the seventh business day following the related payday is deemed to have made a timely deposit.	

Tax Treatment of Contributions

Income Tax

The employer deducts its matching (or nonelective) contributions, and its employees can exclude these contributions from their gross income. The employee's salary reduction contribution is not subject to current income tax and therefore is not subject to federal income tax withholding.

Payroll Taxes

An employee's salary reduction contributions are subject to social security, Medicare and federal unemployment (FUTA) taxes. The employer's matching and nonelective contributions are not subject to these taxes.

Distributions (Withdrawals) from SIMPLE IRAs

Distributions from a SIMPLE IRA are subject to the IRA rules, including the requirement that distributions begin by age 70½, and generally are includible in income for the year received.

Tax-free rollovers can be made from one SIMPLE IRA into another SIMPLE IRA. However, a rollover from a SIMPLE IRA to a non-SIMPLE IRA can be made tax-free only after participating in the SIMPLE IRA plan for at least two years.

Withdrawals from an IRA before age 59½ generally are subject to a 10% additional tax, unless a penalty exception applies. However, for withdrawals from SIMPLE IRAs, the additional tax is increased to 25% if funds are withdrawn within two years of beginning participation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. When a business is assessing whether it meets the employee limit requirement necessary for setting up a SIMPLE IRA, which of the following employees must be taken into account?

   a. All full-time employees who received at least $12,500 from the business in the preceding year that are eligible to participate.

   b. All part-time employees who received at least $4,500 from the business in the preceding year.

   c. All seasonal employees who received at least $4,000 from the business in the preceding year.

   d. All full-time, part-time, and seasonal employees who received at least $5,000 from the business in the preceding year, even if they are not eligible to participate.

8. For 2010, Andy has elected to defer $10,000 of his annual salary of $40,000 to a SIMPLE IRA established by his employer Dawson Supply Company. In keeping with applicable requirements, Dawson Supply Company's matching contribution to Andy's SIMPLE IRA can be which of the following amounts?

   a. $300.

   b. $800.

   c. $1,250.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. When a business is assessing whether it meets the employee limit requirement necessary for setting up a SIMPLE IRA, which of the following employees must be taken into account? **(Page 42)**

   a. All full-time employees who received at least $12,500 from the business in the preceding year that are eligible to participate. [This answer is incorrect. In order for a business to be required to take into account full-time employees when determining whether it meets the employee limit requirement for setting up a SIMPLE IRA, those full-time employees must have received a compensation threshold for the preceding year of at least $5,000, even if they are not eligible to participate.]

   b. All part-time employees who received at least $4,500 from the business in the preceding year. [This answer is incorrect. When determining whether it meets the employee limit requirement for setting up a SIMPLE IRA, a business must take into account part-time employees who received compensation of at least $5,000 during the preceding year.]

   c. All seasonal employees who received at least $4,000 from the business in the preceding year. [This answer is incorrect. In order for seasonal employees to be taken into account by a business when determining whether it meets the employee limit requirement for setting up a SIMPLE IRA, they must have received compensation of at least $5,000 during the preceding year.]

   d. All full-time, part-time, and seasonal employees who received at least $5,000 from the business in the preceding year, even if they are not eligible to participate. [This answer is correct. A business must take into account all full-time, part-time and seasonal employees who received $5,000 or more in compensation from the business for the preceding year, regardless of whether they are eligible to participate.]

8. For 2010, Andy has elected to defer $10,000 of his annual salary of $40,000 to a SIMPLE IRA established by his employer Dawson Supply Company. In keeping with applicable requirements, Dawson Supply Company's matching contribution to Andy's SIMPLE IRA can be which of the following amounts? **(Page 45)**

   a. $300. [This answer is incorrect. If an employer chooses a matching contribution less than 3%, the percentage contributed to the employee's SIMPLE IRA must be at least 1%.]

   b. $800. [This answer is correct. Under a SIMPLE IRA plan, an employer may contribute not less than 1% of an employee's annual salary in matching contributions and no more than 3%. Therefore, Dawson Supply Company may make matching contributions to Andy's SIMPLE IRA in any amount from $400 to $1,200 (between 1% and 3% of Andy's annual salary of $40,000.]

   c. $1,250. [This answer is incorrect. A matching contribution by Dawson Supply Company to Andy's SIMPLE IRA cannot be $1,250 because the employer match is limited to 3% of the employee's salary.]

EXAMINATION FOR CPE CREDIT

Lesson 3

Determine the best answer for each question below. Then log on to our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

7. Which of the following statements regarding a SIMPLE IRA plan is accurate?

   a. It is a qualified plan.

   b. It is subject to nondiscrimination rules.

   c. It is not subject to the top-heavy rules.

   d. Simplified reporting requirements do not apply.

8. Judy turns 50 on December 4, 2010. What is the maximum amount she can contribute to her SIMPLE IRA plan in 2010?

   a. $11,500.

   b. $13,500.

   c. $14,000.

   d. $14,500.

Lesson 4: SEP Plans

Learning Objectives

Completion of this lesson will enable you to:

- Identify the requirements of SEP plans.

What Is a SEP Plan

A *simplified employee pension* (SEP) plan is a written arrangement that allows an employer to make contributions to IRAs established by or on behalf of each qualifying employee. Although designed for small businesses, any employer (sole proprietorship, partnership, LLC or corporation), regardless of its size or number of employees, may establish a SEP. Subject to limitations, contributions to a SEP are deductible by the employer and excluded from the employees' income until withdrawn. In addition, federal income tax on the employee's account earnings is deferred until distributed.

Employer Advantages of a SEP

1. Contributions to a SEP are tax deductible, and the employer pays no taxes on the earnings on the investments.
2. The employer is not locked into making contributions every year. In fact, the employer decides each year whether, and how much, to contribute to its employees' SEP IRAs.
3. Generally, the employer does not have to file any documents with the government.
4. Sole proprietors, partnerships, LLCs and corporations, including S corporations, can set up SEPs.
5. The employer may be eligible for a tax credit of up to $500 per year for each of the first three years for the cost of starting the plan.
6. Administrative costs are low.

Setting Up a SEP Plan

Who Is Eligible?

Although designed for small businesses, any employer, regardless of its size or number of employees, generally may establish and maintain a SEP. Employer includes:

- Sole proprietorship,
- Partnership,
- Limited liability company (LLC) or
- Corporation.

How to Set Up

There are three basic steps in setting up a SEP:

1. The employer must execute a formal written agreement to provide benefits to all eligible employees.
2. A SEP IRA must be set up by or for each eligible employee.
3. Each eligible employee is given certain information about the SEP for that year.

Tax Credit for Expenses of New Plan

A small business adopting a new SEP is eligible for a nonrefundable income tax credit for administrative and retirement education expenses paid. The credit equals 50% of the first $1,000 of qualified expenses for each of the first three years of the plan. The first credit year generally is the tax year the plan becomes effective. However, the small business may elect to claim the credit in the preceding year.

The 50% of qualifying expenses offset by the credit is not deductible. However, the other 50% of such expenses (along with other expenses above the $1,000 limit) is deductible to the extent permitted under present law. Eligible small employers claim the credit on Form 8881.

Eligible employers. The credit is available to an employer that did not employ in the preceding year more than 100 employees with compensation of at least $5,000. For an employer to be eligible for the credit, the plan must cover at least one non-highly compensated employee. For this purpose, the definition of *highly compensated employee* as defined in Section 414(q)(1) presumably applies. Thus, for 2010, a *highly compensated employee* is any employee who (1) was a greater-than-5% owner at any time during the current or preceding year or (2) for the preceding year, had compensation from the employer in excess of $110,000 and, if the employer so elects, was in the top-paid group of employees.

An eligible employer cannot have, during the three-tax-year period immediately before the first year for which the credit would be available, established or maintained a plan for substantially the same employees that are in the new plan.

Qualified expenses. Qualified startup costs are ordinary and necessary expenses of an eligible employer which are paid or incurred in connection with:

- Establishing or administrating an eligible employer plan or
- The retirement-related education of employees with respect to the eligible employer plan.

Formal Written Agreement

To establish a SEP, the employer must execute a written instrument that includes (a) the name of the employer, (b) the requirements for employee participation and (c) the signature of a responsible official of the employer. The instrument must be executed within the time prescribed for making deductible contributions (that is, by the deadline, including extensions, for filing the employer’s tax return). The following are acceptable options for satisfying the written instrument requirement:

- Model IRS agreement (using Form 5305-SEP).

- Prototype SEP sponsored by a qualified financial institution (such as a bank, mutual fund or insurance company).
- Individually designed plan.

Model IRS Agreement (Form 5305-SEP)

The simplest way to establish a SEP is to complete and sign Form 5305-SEP (reproduced in Tab 12). If Form 5305-SEP is adopted without modification, the SEP will satisfy all necessary requirements and no approval or opinion letter is needed. The executed agreement is not filed with the IRS; it is simply maintained as part of the employer's permanent records.

If Form 5305-SEP is adopted, the employees' SEP IRAs must be established using Forms 5305 or 5305-A, or they must be master or prototype IRAs for which the IRS has issued a favorable opinion letter.

An employer who adopts Form 5305-SEP agrees to the following:

- Contributions are discretionary. However, if made, contributions for each employee will be limited for 2010 to the smaller of $49,000 or 25% of the employee's compensation. Compensation for this purpose is limited to $245,000 for 2010.
- Contributions will be made in an amount that is the same percentage of total compensation for every employee.
- The SEP will be a calendar year plan.

When not to use Form 5305-SEP. Form 5305-SEP cannot be used to adopt a SEP if any of the following apply:

- The employer currently maintains a qualified retirement plan. An employer that sponsors a qualified plan can adopt a nonmodel SEP if the appropriate language limiting benefits and/or contributions is included.
- The employer has eligible employees for whom SEP IRAs have not been established. An employer should be able to establish SEP IRAs for eligible employees unable or unwilling to establish their own.

  Note: Finding a custodian willing to set up an IRA without the owner's (that is, the employee's) signature may be difficult. Furthermore, the employer, as a fiduciary of such an account, would be responsible for the account's investment and thus could be held liable should the investment perform poorly or if the choice of investment is too conservative.
- The employer uses the services of leased employees.
- The employer is a member of an affiliated service group [as described in Section 414(m)], a controlled group of corporations [as described in Section 414(b)] or trades or businesses under common control [as described in Section 414(c)] unless all eligible employees of all the members of such groups are covered.
- The employer will not pay the cost of the SEP contributions.

Prototype SEP

An employer can adopt a prototype SEP developed by a financial institution, such as a bank, savings and loan association or regulated investment company. Prototype SEPs generally are used by employers who want to incorporate options in their SEPs unavailable under the IRS model agreement, such as fiscal year-ends or permitted disparity. Also, an employer that currently sponsors a qualified plan can adopt a prototype SEP if the appropriate language limiting contributions is included.

The developer of a prototype plan (for example, the financial institution) files Form 5306-A [*Application for Approval of Prototype Simplified Employee Pension (SEP) or Savings Incentive Match Plan for Employees of Small Employers (SIMPLE IRA Plan)*] to request a favorable opinion letter from the IRS. The plan is then made available to its customers, who can rely on the opinion letter if:

- Contributions are made to SEP IRAs established using Forms 5305 or 5305-A, or to master or prototype SEP IRAs for which the IRS has issued a favorable opinion letter and
- Section 415 contribution limits are not exceeded.

Although prototype SEPs may offer options unavailable under the IRS model agreements, it may be difficult to find one that meets the employer's needs but does not limit plan investments to only those offered by the financial institution that developed the plan. For this reason, some employers prefer to use individually designed SEPs.

Individually Designed SEP

An employer can design and adopt an individually designed SEP. However, except for employers that wish to maintain a SEP and another qualified plan, individually designed SEPs seldom are needed. They are expensive and rarely can provide features that cannot be found in an IRS model SEP or in a prototype SEP.

Note: There is little flexibility with SEPs. Consequently, most individually designed plans resemble the IRS model agreements with the language curing the problem preventing the employer from using the model agreement or providing the option unavailable under the model agreement.

Employers sponsoring individually designed SEPs may request a private letter ruling from the IRS National Office. A user fee of $10,000 must be paid with such a request. However, small employers (100 or fewer employees with at least $5,000 of compensation) are exempt from paying the otherwise applicable IRS user fees generally imposed on an application for a determination letter, provided there is at least one non-highly compensated employee (NHCE), and the application is submitted in the first five years of the plan (or later, if a remedial amendment period applies). The waiver of user fees is effective for requests made after 2001.

An employer is not required to receive the IRS approval (that is, a favorable letter ruling) of a SEP. Any arrangement that meets the requirements of Section 408(k) will receive the favorable tax treatment accorded to SEPs. However, it is always preferable to have the IRS approval for a plan. Finding an IRA custodian that will accept contributions from a SEP that has not received the IRS approval may be difficult.

Covered Employees

Participation Requirements

SEP IRAs are set up for, at a minimum, each eligible employee (defined below). A SEP IRA may have to be set up for a leased employee but does not need to be set up for excludable employees (defined in the next column).

Eligible employees. For the plan to qualify as a SEP, the employer must make contributions for each employee who has:

- Attained age 21,
- Performed services for the employer for at least three of the immediately preceding five years and
- Received at least a stated amount in compensation [indexed annually for inflation—$550 for 2010 (IR 2009-94)].

A SEP can provide less restrictive participation requirements (but not more restrictive ones).

Example: Big Part Company (BPC) is considering establishing a SEP under which it intends to make a 2010 contribution for all employees meeting the age, service and compensation requirements applying to SEPs. During 2007, 2008 and 2009, BPC hired Sue Ellen, a college student, to help take inventory. Sue Ellen worked 20 hours and earned $200 in each of those years. During 2010, the year Sue Ellen turned 21, she worked the entire summer (480 hours) for BPC, earning $4,800. If BPC makes a SEP contribution for 2010, it must make a contribution for Sue Ellen. Sue Ellen meets the plan's participation requirements for 2010 because she:

1. Is age 21,
2. Performed services for BPC during three of the preceding five years and
3. Received compensation for 2010 of at least $550.

Therefore, if BPC makes a SEP contribution for 2010, it must make a contribution for Sue Ellen. For the service requirement, 2007–2009 are counted even though Sue Ellen did not meet the age or compensation requirement in those years.

Employee. An *employee* also may be a self-employed person as well as an owner-employee who has earned income. In other words, an owner can contribute to a SEP IRA on his own behalf.

Strategy: The service requirements for SEPs may be amended on an annual basis so that all employees of a recently established employer are eligible the first year. The requirements can be amended each year until the maximum statutory period is reached at the point when the company has been in existence for at least five years. This enables owners to participate immediately, yet in the future, the plan can require satisfaction of a service requirement.

Employees Who Have Reached Age 70½

Employers cannot deny participation to employees solely because they have reached age 70½ because the rule that prohibits traditional IRA contributions after that age does not apply to SEPs.

Excludable Employees

The following employees can be excluded from coverage under a SEP:

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the union.
- Nonresident alien employees who have received no U.S.-source wages, salaries or other personal services compensation.

SEP Plan Contributions

The SEP rules permit an employer to contribute a limited amount of money each year to each employee's SEP IRA. A self-employed individual can contribute to his own SEP IRA. Contributions must be in the form of money (cash, check or money order). Property cannot be contributed. A SEP IRA cannot be a Roth IRA.

How Much Can Be Contributed?

Contribution limits. For 2010, contributions to an employee's SEP IRA are excludable from the employee's income to the extent they do not exceed the lesser of:

- $49,000 or
- 25% of the employee's compensation (up to a maximum compensation of $245,000).

Annual compensation limit. An employer cannot consider the part of an employee's compensation over $245,000 when figuring the contribution limit for that employee. However, $49,000 is the maximum contribution for an eligible employee.

Example: Build-It Company maintains a SEP plan for eligible employees. Contributions to the SEP under the terms of the plan agreement are 25% of an employee's compensation. Tom, an eligible employee of Build-It Company, earns $300,000 in 2010. The maximum contribution to Tom's SEP IRA is limited to $49,000, calculated as follows:

Annual compensation (limited to the lesser of $245,000 or actual compensation)	$245,000
SEP Contribution %..	× 25%
Compensation limit × Contribution %	$ 61,250
Maximum contribution allowed to Tom's SEP IRA	$ 49,000

More than one plan. If an employer contributes to a defined contribution plan, annual additions to an account are limited to the lesser of $49,000 or 100% of the participant's compensation. When figuring this limit, the employer must add its contributions to all defined contribution plans.

Because a SEP is considered a defined contribution plan for this limit, employer contributions to a SEP must be added to its contributions to other defined contribution plans.

Funding Rules

- Contributions to a SEP must be immediately 100% vested (with no withdrawal restrictions).
- Contributions must be made pursuant to a written allocation formula that describes how the allocation is computed and specifies the requirements an employee has to meet to share in an allocation. (For employers adopting the model IRS agreement, the completed Form 5305-SEP satisfies the requirement for a written allocation formula.)
- Contributions must be nondiscriminatory. This normally means employer contributions must bear a uniform relationship to the compensation of each eligible employee, up to the applicable compensation limit (which is $245,000 for 2010). However, if the plan is integrated with social security (referred to as permitted disparity), employees earning more than the social security wage base ($106,800 for 2010) may be allocated a greater percentage of the employer's contribution, as long as employees earning less than the wage base receive certain minimum benefits. An employer using the IRS model Form 5305-SEP to establish a plan may not integrate the plan.
- If the plan is top-heavy, certain minimum contributions must be made. Top-heavy rules also apply to Salary Reduction Simplified Employee Pension Plans (SARSEPs).

When Are Contributions Made?

When contributions must be made to be deductible. To take a deduction for contributions for a particular year, the contributions made for that year must be made by the due date (including extensions) of the employer's income tax return for that year.

If the SEP is maintained on a calendar year, contributions made for a year are deductible for the tax year with which (or within which) the calendar year ends. If the SEP is maintained on the employer's tax year, contributions are deductible for that tax year.

Tax-year basis of the SEP. An employer may elect to maintain the SEP on a fiscal year basis that is the same as the employer's tax year. In this case, the 25% limit is applied to compensation paid during the employer's tax year. However, plans established using the IRS model documents (Forms 5305-SEP and 5305A-SEP) must be maintained on a calendar-year basis. Thus, a prototype or individually designed plan must be used for a plan to elect a fiscal year (that is, the employer's tax year).

Excess Contributions

Contributions that exceed the SEP contribution limit per participant are included in the employee's income in the year the contribution was made and treated as traditional IRA contributions made by the employee for that year. As such, the excess is subject to IRA contribution and deduction limits.

Note: Contributions that are more than the deduction limit for employers may be carried over to the next year.

Penalty for Excess Contributions

Contribution to the participant's IRA that exceed the participant's contribution and deduction limits may also be subject to a 6% excise tax. The excise tax applies unless the excess contribution, along with allocable income, is distributed by the due date (including extensions) for filing the individual's federal income tax return. The correction is made by the participant.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. There are three basic steps to be followed when setting up a simplified employee pension (SEP). Which of the following accurately describes one of those three steps?

   a. Each eligible employee is given information concerning the SEP when the plan is adopted only.

   b. A written agreement to provide benefits to all eligible employees must be made by the employer.

   c. A SEP IRA must be set up by the employer for each eligible employee.

10. If an employer establishes a SEP by completing and signing Form 5305-SEP, which of the following statements is correct?

    a. Employer contributions are required.

    b. The employer's contribution percentage varies depending on each employee's total compensation.

    c. The employer must establish the SEP as a fiscal year plan.

    d. An opinion letter from the IRS is not required.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. There are three basic steps to be followed when setting up a simplified employee pension (SEP). Which of the following accurately describes one of those three steps? **(Page 52)**

   a. Each eligible employee is given information concerning the SEP when the plan is adopted only. [This answer is incorrect. Sponsoring employers must give employees information regarding the plan when the plan is adopted per Prop. Reg. 1.408-9(a) as well as provide annual disclosures to participants regarding the mount of contributions made to their IRAs.]

   b. A written agreement to provide benefits to all eligible employees must be made by the employer. [This answer is correct. The employer must execute a formal written agreement to provide benefits to all eligible employees. Form 5305-SEP may be used for this purpose.]

   c. A SEP IRA must be set up by the employer for each eligible employee. [This answer is incorrect. A SEP IRA may be set up by the employer, or by each eligible employee. An employee may also be a self-employed person as well as an owner-employee who has earned income. Therefore, an owner can contribute to a SEP IRA on his own behalf.]

10. If an employer establishes a SEP by completing and signing Form 5305-SEP, which of the following statements is correct? **(Page 53)**

    a. Employer contributions are required. [This answer is incorrect. For an employer who adopts Form 5305-SEP, contributions are discretionary.]

    b. The employer's contribution percentage varies depending on each employee's total compensation. [This answer is incorrect. Employer contributions must be made in an amount that is the same percentage of total compensation for every employee.]

    c. The employer must establish the SEP as a fiscal year plan. [This answer is incorrect. The employer must establish the SEP as a calendar year plan, not a fiscal year plan.]

    d. An opinion letter from the IRS is not required. [This answer is correct. If Form 5305-SEP is adopted without modification, the SEP will satisfy all necessary requirements and no approval or opinion letter is needed.]

EXAMINATION FOR CPE CREDIT

Lesson 4

Determine the best answer for each question below. Then log on to our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

9. Which of the following statements is true regarding a SEP plan?

   a. It can only be established by an employer with 100 or fewer employees.

   b. It is only available for employees of sole proprietorships, partnerships, LLCs, and corporations.

   c. The employer does not have to make contributions to its employees' SEP IRAs every year.

   d. The employer may not maintain another qualified plan.

10. In 2010, John earns $185,000 from his employer, Bosco Widget Company. How much can Bosco Widget Company contribute to John's SEP IRA for 2010?

    a. $37,000.

    b. $46,250.

    c. $49,000.

    d. Depends on John's age.

Lesson 5: 401(k) and 403(b) Plans

Learning Objectives

Completion of this lesson will enable you to:

- Identify the various requirements of 401(k) and 403(b) plans, compare and contrast these types of plans, and determine the allowable contributions to these types of plans.

What Is a 401(k) Plan?

A *401(k) plan* is a type of profit-sharing or stock bonus plan to which employees can choose to have part of their compensation contributed on a before-tax basis instead of receiving the compensation in cash. This contribution is called an *elective deferral* because participants elect to set aside the money, and they defer the tax on the money, along with investment gains or losses, until it is distributed to them.

When the 401(k) plan is part of a profit-sharing plan, employers still have the advantage of flexibility in making discretionary contributions. Employers that cannot afford to make any discretionary contributions may still find a 401(k) plan an attractive option to offer employees who wish to contribute on their own.

Employees can elect to defer only future compensation. In other words, only compensation that has not yet been earned or that the employee does not have the right to receive is eligible for salary deferrals.

401(k) Plan Requirements

To qualify as a 401(k) plan, the plan must satisfy all the requirements of IRC Sec. 401(k). These include the following:

1. *Limits on plan distributions*. These limits restrict an employee from receiving a distribution of elective deferrals only because of completing a stated number of years of service or the passing of a fixed number of years.
2. *Nonforfeitability of salary deferral contributions.* Salary deferrals must always be 100% vested.
3. *Not more than one year of service can be required to participate in a salary deferral feature*. For other contributions (that is, employer matching or nonelective contributions), the participation requirement may be extended to two years if these contributions are nonforfeitable (100% vested).
4. *Benefits not contingent*. Benefits (other than matching contributions) must not be contingent on the employee's election to make salary deferrals.
5. *Employees eligible to participate in the salary deferral feature (regardless of whether they elect to contribute) must satisfy the coverage tests*. Under the coverage tests, the plan must meet either the ratio percentage test or the average benefit test.
6. *Limitations on the maximum salary deferrals*. The limit for 2010 is $16,500. However, a 401(k) plan may allow individuals who have attained at least age 50 by the calendar year-end to make catch-up contributions. The allowable catch-up contribution that applies to

401(k) plans for 2010 is $5,500. Catch-up contributions are not taken into account in computing the otherwise applicable dollar limit on elective deferrals ($16,500 for 2010). In addition, catch-up contributions are not subject to any other contribution limits or otherwise applicable nondiscrimination rules. However, they must be available to all participants age 50 or over by the calendar year-end on an equal basis. An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.

Setting Up a 401(k) Plan

Who Can Set Up

A 401(k) plan cannot be created by the employee. The plan is adopted by the employer. State and local government employers are ineligible to set up a 401(k) plan for employees.

401(k) plans for partnerships, LLCs and proprietorships. For purposes of 401(k) plans, self-employed individuals [that is, sole proprietors, partners of a partnership and members (subject to self-employment tax) of a limited liability company (LLC)] are considered *employees*. As such, these individuals are eligible to participate in the 401(k) plan. Any pretax contributions made on behalf of a self-employed individual are treated as elective contributions. Matching contributions for self-employed individuals are the same as for other participants and are not treated as elective contributions or included in the Section 402(g) elective deferral limit.

Self-employed individuals must make their 401(k) elections before the last day of the tax year.

Deadline for Establishing

Generally, a plan must be established by year end. However, the plan must be established before any employees defer compensation (that is, only future compensation may be deferred). Earlier deadlines apply for safe harbor plans.

How to Set Up

An employer must take certain basic actions to establish a 401(k) plan. One of the employer's first decisions will be whether to set up the plan itself or to consult a professional or financial institution (such as a bank, mutual fund provider or insurance company) to help with establishing and maintaining the plan. In addition, there are four initial steps for setting up a 401(k) plan:

1. Adopt a written plan document,
2. Arrange a trust fund for the plan's assets,
3. Develop a recordkeeping system and
4. Provide plan information to employees eligible to participate.

Adopt a written plan document. Plans begin with a written document that serves as the foundation for day-to-day plan operations. If an employer has hired someone to help with the plan, that person likely will provide it. If not, an employer should consider obtaining assistance from a financial institution or retirement plan professional. In either case, the employer will be bound by the terms of the plan document.

Before beginning a plan document, however, the employer will need to decide on the type of 401(k) plan that is best for the company—a traditional 401(k) plan, a safe harbor 401(k) plan or an automatic enrollment 401(k) plan. In all of these plans, participants can make contributions through salary deductions.

Note: A 401(k) plan can be set up as SIMPLE plan.

Arrange a trust fund for the plan's assets. A plan's assets must be held in trust to assure that assets are used solely to benefit the participants and their beneficiaries. The trust must have at least one trustee to handle contributions, plan investments and distributions. Since the financial integrity of the plan depends on the trustee, selecting a trustee is one of the most important decisions the employer will make in establishing a 401(k) plan. Plans set up through insurance contracts do not need to be held in trust.

Develop a recordkeeping system. An accurate recordkeeping system will track and properly attribute contributions, earnings, losses, plan investments, expenses and benefit distributions. If a contract administrator or financial institution assists in managing the plan, that entity typically will help keep the required records. In addition, a recordkeeping system will help the employer, the plan administrator or financial provider prepare the plan's annual return/report that must be filed with the federal government.

Provide plan information to employees eligible to participate. The employer must notify employees who are eligible to participate in the plan about certain benefits, rights and features. In addition, a summary plan description (SPD) must be provided to all participants. The SPD is the primary vehicle to inform participants and beneficiaries about the plan and how it operates. The SPD typically is created with the plan document.

The employer also may want to provide employees with information that discusses the advantages of a 401(k) plan. The benefits to employees—such as pretax contributions to a 401(k) plan (or tax-free distributions in the case of Roth contributions), employer contributions (if the employer chooses to make them) and compounded tax-deferred earnings—help highlight the advantages of participating in the plan.

Employees Who Must Be Covered

Typically, a plan includes a mix of rank-and-file employees and owner/managers. However, some employees may be excluded from a 401(k) plan if they:

- Have not attained age 21;
- Have not completed a year of service or
- Are covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good faith bargaining.

Employees cannot be excluded from a plan merely because they are older workers.

401(k) Plan Contributions

A 401(k) plan allows two different kinds of contributions, employee elective deferrals and employer contributions.

Employee Elective Deferral

There is a limit on the amount an employee can defer each year under 401(k) plans. The plan must provide that employees cannot defer more than the limit that applies for a particular year ($16,500 for 2010). If, in conjunction with any other plans the employee participates in, the deferral limit is exceeded, the difference is included in the employee's gross income.

In addition to elective deferrals made by employees, other types of contributions can be made to 401(k) plans.

Catch-up contributions. A 401(k) plan can permit participants who are age 50 or older at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2010 is $5,500, so these individuals can contribute up to $22,000 to their 401(k) accounts. Elective deferrals are not treated as catch-up contributions for 2010 until they exceed the $16,500 limit, the actual deferral percentage (ADP) test limit of Section 401(k)(3). However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts:

- The catch-up contribution limit or
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

After-tax contributions. All plans, including 401(k) plans, may allow employees to make after-tax contributions.

Employer Contributions

401(k) plans also permit the employer to contribute (and deduct) up to 25% of total participant compensation (up to $245,000 per participant for 2010) to the plan. This contribution is treated as a profit-sharing plan contribution. Elective deferrals are not counted towards the 25%-of-compensation limit on the employer contribution.

Matching contributions. Elective deferrals must meet certain tests to ensure that they benefit rank-and-file employees as well as highly compensated employees (HCEs). This may present a problem because lower paid employees often elect to receive cash in lieu of deferring salary. To encourage their participation, employers can offer to *match* salary deferrals under a formula stated in the plan. The employer can also set a cap on the maximum amount they will match. For example, the employer may match 50¢ of each dollar, up to a maximum of 6% of compensation (resulting in a maximum match amount of 3% of compensation). Matching contributions may also be discretionary (that is, decided at year-end), but must be made according to the terms of the plan document.

Limit on Additions to Any Participant's Account

Employer and employee contributions and forfeitures (nonvested employer contributions of terminated participants) are subject to a per-employee overall annual limitation. This limit is the lesser of:

- 100% of the employee's compensation or
- $49,000 (for 2010).

In addition, the amount employees can contribute under any 401(k) plan is limited to $16,500 for 2010.

All 401(k) plans can allow catch-up contributions of $5,500 (for 2010) for employees age 50 or over.

Safe-Harbor 401(k) Plans

Avoid Annual Nondiscrimination Testing

Safe-harbor 401(k) plans allow an employer to make certain contributions to a 401(k) plan as an alternate way of meeting the nondiscrimination requirements. Under this safe harbor, a 401(k) plan passes the ADP test if: (1) it meets certain notice and vesting requirements, (2) all safe harbor contributions and match amounts are fully vested, (3) the plan document states that the ADP safe harbor testing method is being used and (4) the employer provides contributions under one of the prescribed methods.

Required Employer Contributions

Contributions may be made under a safe-harbor 401(k) plan using any of the following methods:

1. Nonelective contribution of at least 3% for each eligible non-highly compensated employee (NHCE). (See *Example #1* on Page 69.)
2. Basic matching formula of:
    a) 100% of the employee's elective contributions up to 3% of compensation and
    b) 50% of the employee's elective contributions in excess of 3%, but no greater than 5% of compensation, where the matching contribution rate for HCEs does not exceed that for the NHCEs. (See *Example #2* on Page 69.)
3. Enhanced matching formula such that:
    a) The rate of the employer's matching contribution does not increase as an employee's rate of elective contribution increases and
    b) The aggregate amount of matching contributions at any elective contribution rate is at least as much as the aggregate amount of matching contributions required under the basic matching formula (for example, 100% of contributions up to 3% of compensation and 50% of contributions from 3% to 5% of compensation). (See *Example #3* on Page 70.)

Automatic Enrollment 401(k)

An automatic enrollment 401(k) plan allows an employer to automatically enroll employees and place deductions from their salaries in certain default investments, unless the employee elects otherwise. This is an effective way for many employers to increase participation in their 401(k) plans.

The Pension Protection Act of 2006 (PPA) encourages employers to add an automatic enrollment feature to their 401(k) plans to improve employees' retirement savings rates.

This encouragement is provided by the creation of safe harbors related to nondiscrimination testing and deemed satisfaction of top-heavy rules, as well as allowing erroneous contributions to be timely distributed without penalty. These rules can be elected after 2007. The PPA provides that automatic enrollment plans meeting certain requirements for specified rates of deferral (unless the employee elects otherwise) and specified notice requirements will be considered qualified automatic contribution arrangements (QACAs). QACAs are afforded certain benefits, including the following, which facilitate their administration:

- Treated as meeting the ADP and ACP tests.
- Allowed to correct such things as erroneous contributions.
- Given six months rather than 2½ months after year-end to distribute excess contributions without incurring the 10% employer excise tax.
- Required to vest matching contributions 100% after two years.
- Required to automatically select a deferral percentage that does not exceed 10% but is at least 3% in the first year and increases each year by 1% until it reaches 6% after four years.

PPA provides that ERISA preempts state wage and garnishment laws that directly or indirectly prohibit automatic enrollment, provided the plan provides an annual notice to the affected employees before the start of each year. Failure to provide this notice can result in a penalty of up to $1,100 per day.

An automatic enrollment feature will be considered a QACA if it:

- Meets certain notice requirements,
- Treats each employee eligible to participate in the arrangement as having elected to have the employer make elective contributions in an amount equal to a qualified percentage of compensation,
- Allows employees to affirmatively elect out of the arrangement,
- Provides either a safe harbor match or a safe harbor 3% employer contribution, and
- Vests all employer contributions when an employee completes at least two years of service.

Nondiscrimination Rules

In order to preserve the tax benefits of a 401(k) plan, the plan must provide substantive benefits for rank-and-file employees, not just business owners and managers. These requirements are called *nondiscrimination rules* and compare both plan participation and contributions of rank-and-file employees to owners/managers.

Traditional 401(k) plans are subject to annual testing to assure that the amount of contributions made on behalf of rank-and-file employees is proportional to contributions made on behalf of owners and managers.

Special nondiscrimination tests. Salary elective deferral contributions must satisfy one of two nondiscrimination tests that apply only to 401(k) plans. Each of these tests relates the average rate of salary deferrals made by highly compensated employees (HCEs) to the comparable average rate for nonhighly compensated employees (NHCE).

1. The *salary deferral rate* is the ratio of the salary deferral contributed by the employee to that employee's compensation. This ratio is known as the *actual deferral percentage* (ADP).
2. Plans that include employee after-tax contributions and plans that provide for employer matching contributions are subject to tests on such contributions that are mathematically identical to the ADP tests that apply to salary deferrals. These tests are referred to as *actual contribution percentage* (ACP) tests.

Note: The ADP and ACP tests do not apply to safe harbor 401(k) plans.

Example #1: John Nagel, D.D.S., Inc., is considering adopting a 401(k) plan. A safe harbor notice would be timely provided to the employees informing them that the corporation would make a 3% nonelective contribution for each eligible NHCE as an alternative to nondiscrimination testing. The average deferral for employees is estimated to be 2% of compensation, which, without the safe harbor 3% contribution, would limit Dr. Nagel to $15,300 [($245,000 × 4%) + $5,500 catch-up] in deferrals. By using the 3% safe harbor contribution, Dr. Nagel can defer $29,350.

Participant	Age	Compensation	Employee 401(k) Deferrals	3% Employer Contribution	Employer Match	Employee Catch-Up Contributions	Total Annual Additions (Allocations)
John Nagel	54	$ 245,000	$ 16,500	$ 7,350	$ 0	$ 5,500	$ 29,350
Betsy Smith	35	40,000	800	1,200	0	0	2,000
Jane Davis	25	25,000	500	750	0	0	1,250
Alisia Barker	27	28,000	560	840	0	0	1,400
Totals		$ 338,000	$ 18,360	$ 10,140	$ 0	$ 5,500	$ 34,000

Example #2: Assume the same facts as in Example #1, but add a basic formula that matches 100% of the employee elective contributions up to 3% of compensation and 50% of the next 2%.

Participant	Age	Compensation	Employee 401(k) Deferral	3% Employer Contribution	Employer Match	Employee Catch-Up Contributions	Total Annual Additions (Allocations)
John Nagel	54	$ 245,000	$ 16,500	$ 7,350	$ 9,800	$ 5,500	$ 39,150
Betsy Smith	35	40,000	800	1,200	800	0	2,800
Jane Davis	25	25,000	500	750	500	0	1,750
Alisia Barker	27	28,000	560	840	560	0	1,960
Totals		$ 338,000	$ 18,360	$ 10,140	$ 11,660	$ 5,500	$ 45,660

Example #3: Assume the same facts as in Example #1, but add an enhanced formula that matches 100% of the employee elective contribution up to 6% of compensation.

Participant	Age	Compensation	Employee 401(k) Deferral	3% Employer Contribution	Employer Match	Employee Catch-Up Contributions	Total Annual Addition (Allocations)
John Nagel	54	$ 245,000	$ 16,500	$ 7,350	$ 14,700	$ 5,500	$ 44,050
Betsy Smith	35	40,000	800	1,200	800	0	2,800
Jane Davis	25	25,000	500	750	500	0	1,750
Alisia Barker	27	28,000	560	840	560	0	1,960
Totals		$ 338,000	$ 18,360	$ 10,140	$ 16,560	$ 5,500	$ 50,560

Highly compensated employee (HCE). An important aspect of performing the ADP and ACP tests is to identify properly the HCEs. HCEs generally include any employee who:

- Was a 5% owner at any time during the year or preceding year (a *5% owner* is someone who owns more than 5% of the business) or
- For the preceding year, had compensation from the employer in excess of $110,000 (for 2010 and subject to cost-of-living adjustments in later years) and, if the employer elects, was a member of the top-paid group (top 20%) of employees.

When determining ownership interests, family aggregation rules apply. These family aggregation rules may affect the treatment of stock owned directly or indirectly by family members. The law treats any individual who is a spouse, child, grandparent or parent of someone who is a 5% owner, or who together with that individual would own more than 5% of a company's stock, as a 5% owner. As a 5% owner, each of these individuals is an HCE for the plan year. It is important to identify the family ownership interests of all company stock and to forward that information to the advisor or persons performing the nondiscrimination tests.

Actual Deferral Percentage

The ADP test compares the average deferral percentage of the prior year NHCEs to the average deferral percentage of the current year HCEs to limit the percentage of compensation deferred by the HCE group. Who is in the HCE group is based on the compensation earned in the prior plan year or ownership in the current or prior plan year. (This is not elective; all plans must use prior year compensation to determine who is in the current year HCE group.) All plans must also use the current year deferrals and compensation to determine the ADP for the HCE group. The ADP of the HCE group is then compared to the ADP of the NHCEs based on prior year data. However, in this case, the plan may elect to use current year data to determine the ADP for the NHCE group. Once a plan elects to use current year data, there are restrictions as to when it can change to the prior year data method.

The ADP test applies to elective deferrals (including both before-tax deferrals and Roth deferrals) of the HCEs and NHCEs.

The ADP test is met if the ADP for the eligible HCEs does not exceed the greater of:

- 125% of the ADP for the group of NHCEs or
- The lesser of:
  - 200% of the ADP for the group of NHCEs or
  - The ADP for the group of NHCEs plus 2%.

Actual Contribution Percentage

Plans including employee after-tax contributions and plans providing for employer matching contributions [referred to as 401(m) plans] are subject to tests on such contributions. These tests are referred to as actual contribution percentage (ACP) tests and are mathematically identical to the ADP tests applicable to salary deferrals.

The ACP test is met if the ACP for the eligible HCEs does not exceed the greater of:

- 125% of the ACP for the group of NHCEs or
- The lesser of:
  - 200% of the ACP for the group of NHCEs or
  - The ACP for the group of NHCEs plus 2%.

Top-Heavy Plans

In addition to ADP and ACP tests for 401(k) plans, employers should perform other tests annually, such as the tests associated with the top-heavy rules, which ensure that the lower paid employees receive a minimum benefit if the plan is top-heavy. A plan is top-heavy when, as of the last day of the preceding plan year, the aggregate value of the plan accounts of key employees exceeds 60% of the aggregate value of the plan accounts for all employees under the plan.

If a 401(k) plan is top-heavy, the employer must contribute up to 3% of compensation for all non-key employees still employed on the last day of the plan year. This contribution is subject to an accelerated vesting schedule requiring participants to be 100% vested after three years; or 20% after two years, 40% after three, 60% after four, 80% after five and 100% after six years.

Key employees. To determine if the plan is top-heavy, the employer must first identify key employees. A *key employee* is an employee (including former or deceased employees), who at any time during the plan year was:

- An officer whose annual compensation from the employer exceeds $160,000 (for 2010),
- A 5% owner of the business (a *5% owner* is someone who owns more than 5% of the business) or
- An employee owning more than 1% of the business and whose compensation exceeds $150,000 for the plan year.

A *non-key employee* is any employee who is not a key employee.

It is important to note the distinction between key employees who count for top-heavy purposes and highly compensated employees (HCEs), who count for the ADP and ACP tests, but not the top-heavy tests.

Remember, when determining ownership interests, family aggregation rules apply. These family aggregation rules may affect the treatment of stock owned directly or indirectly by family members. The rules treat any individual who is a spouse, child, grandparent or parent of someone who is a 5% owner, or who together with that individual would own more than 5% of a company's stock, as a 5% owner. As a 5% owner, the law considers each of these individuals a key employee for the plan year. It's important to identify the family ownership interests of all company stock and to forward that information to the advisor or person performing the nondiscrimination tests.

Note: SIMPLE 401(k) plans and certain safe harbor 401(k) plans are not subject to the top-heavy rules.

Excess Deferrals

If the total of an employee's deferrals is more than the annual limit, the employee can have the difference (called an *excess deferral*) paid out of any of the plans that permit these distributions. He must notify the plan by April 15 of the following year (or an earlier date specified in the plan) of the amount to be paid from each plan. The plan must then pay the employee that amount by April 15.

Excess Withdrawn By April 15

If the employee takes out the excess deferral by April 15 of the following year (that is, April 15, 2011 for 2010 excess deferrals), it is not reported again by including it in the employee's gross income for the year withdrawn. However, any income earned on the excess deferral taken out is taxable in the tax year in which it is taken out. The distribution is not subject to the additional 10% tax on early distributions.

If the employee takes out part of the excess deferral and the income on it, the distribution is treated as made proportionately from the excess deferral and the income.

Excess Not Withdrawn By April 15

If the employee does not take out the excess deferral by April 15 of the following year, the excess, though taxable in the year contributed, is not included in the employee's cost basis in figuring the taxable amount of any eventual benefits or distributions under the plan. In effect, an excess deferral left in the plan is taxed twice, once when contributed and again when distributed. Also, if the entire deferral is allowed to stay in the plan, the plan may not be a qualified plan.

Consequences of an untimely distribution. Iif the excess deferrals arise under one or more plans of the employer and these excess deferrals are not withdrawn by April 15, each affected plan of the employer is subject to disqualification and would need to go through Employee Plans Compliance Resolution System (EPCRS).

Under EPCRS, these excess deferrals are still subject to double taxation; that is, they are taxed both in the year contributed to the plan and in the year distributed from the plan.

These late distributions could be subject to the 10% early distribution tax, 20% withholding and spousal consent requirements.

Excess deferrals distributed to HCEs are included in the ADP test in the year such amounts were deferred. Excess deferrals distributed to NHCEs are not included in the ADP test as long as all deferrals were made under the plan of one employer. Excess deferrals not timely distributed by April 15 are included in annual additions for the year deferred.

Reporting Corrective Distributions

Corrective distributions under Section 401(k) plans and Section 403(b) salary reduction agreements of excess contributions, excess deferrals or excess aggregate contributions, along with the income allocable to these corrective distributions, are not eligible rollover distributions. Excess annual additions of 401(k) elective deferrals (and allocable earnings) returned because of Section 415 limitations are also not eligible rollover distributions. Excess deferrals under IRC Sec. 402(g) are not subject to FITW. The reporting of corrective distributions on Form 1099-R depends on the timing of the refunds and the type of distribution (that is, excess contribution, excess deferral, etc.).

Example: WIN Corp. failed the ADP test for their 401(k) plan for the plan year ended December 31, 2010. The testing was completed March 10, 2011 and indicated that the test could be passed by refunding $2,000 plus earnings to Bob Jones, the sole shareholder of the corporation. WIN Corp. can refund the excess by March 15, 2011 and avoid a 10% excise tax. WIN Corp. will issue a 2011 Form 1099-R to Bob to report the $2,000 excess contribution (plus earnings). Bob will include the $2,000 (plus earnings) in his 2011 federal income tax return.

Participant Loans

Many 401(k) plans permit loans to plan participants. Plan sponsors should make sure that their plan documents allow for loans before allowing participants to borrow money from the plan. Some plan documents include a complete description of rules that participants must follow. Others make only a short statement that the plan allows participant loans, subject to a separately written loan program.

A loan to a participant must meet a number of rules to prevent the law from treating it as a taxable distribution to the participant. The rules are:

1. The plan must base the loan on a legally enforceable agreement.
    a) The agreement can be a paper or electronic written document that states the date and amount of the loan and binds the participant to a repayment schedule that would ensure he repays the loan.
    b) The participant must adequately secure the loan and the terms of the loan, including the interest rate and repayment schedule, should be similar to what a participant might be able to receive from a financial institution.
2. The amount of the loan cannot exceed the lesser of 50% of the participant's vested account balance or $50,000.
    a) An exception allows a participant to borrow up to $10,000, even if it exceeds 50% of his vested account balance.

b) If the participant previously took out another loan, then the plan sponsor must reduce the $50,000 limit of the new loan by the highest amount owed by the participant on other participant loans during the one-year period ending on the day before the new loan.

3. The terms of the loan should require the participant to make level amortized repayments at least quarterly.
   a) Each payment should include an allocation of principal and interest.
   b) The participant must fully repay the loan within five years from the date of the loan, unless the participant uses the loan amount to purchase his main home.
4. Special exception for leave of absence:
   a) A plan may permit a participant to suspend repayments for no longer than a year while he is on a leave of absence.
   b) The plan administrator may not extend the loan's maximum repayment period.
   c) Upon return from leave of absence, the participant will be required to make additional payments on the loan in order to ensure that he fully repays it within the five-year-period by either:
      i) Increasing the installment amounts owed over the remaining period of the loan or
      ii) Keeping the installment amounts the same, but making a catch up payment for the missed installments that occurred during the leave of absence.

Note: A plan may suspend loan payments for more than one year for an employee performing military service. In this case, the employee must repay the loan within five years from the date of the loan, plus the period of military service.

Prohibited Loans

Prohibited transactions are generally any direct or indirect transfer to, or use by or for the benefit of, a *disqualified person*, of a plan's income or assets. Therefore, a loan from the plan to a *disqualified person* may be a prohibited transaction unless specific requirements are met. Prohibited transactions are subject to an excise tax.

Disqualified persons include, among others, a 50% owner (and family members), fiduciaries and persons who provide service to the plan.

Loans to disqualified persons must meet certain requirements to avoid being a prohibited transaction. Loans that are prohibited transactions are generally subject to a 15% excise tax on the amount involved. The *amount involved* generally refers to fair market interest for the use of the plan's money by the disqualified person. The tax is payable by the disqualified person.

For the law not to consider a loan a prohibited transaction, the loan must be:

- Made available to all participants or beneficiaries on a reasonably equivalent basis,
- Made available to highly compensated employees in an amount no greater than the amount made available to other employees,
- Made in accordance with specific provisions stated in the plan,
- Bear a reasonable rate of interest and
- Be adequately secured.

403(b) Plans

What Is a 403(b) Plan?

A *403(b) plan*, also known as a *tax-sheltered annuity (TSA) plan*, is a retirement plan for certain employees of public schools, employees of certain tax-exempt organizations and certain ministers.

Individual accounts in a 403(b) plan can be any of the following types:

- An *annuity contract*, which is a contract provided through an insurance company.
- A *custodial account*, which is an account invested in mutual funds.
- A retirement income account set up for church employees. Generally, retirement income accounts can invest in either annuities or mutual funds.

Who Can Participate in a 403(b) Plan?

Any eligible employee can participate in a 403(b) plan.

Eligible employees. The following employees are eligible to participate in a 403(b) plan:

- Employees of tax-exempt organizations established under IRC Sec. 501(c)(3). These organizations are usually referred to as Section 501(c)(3) organizations or simply 501(c)(3) organizations.
- Employees of public school systems who are involved in the day-to-day operations of a school.
- Employees of cooperative hospital service organizations.
- Civilian faculty and staff of the Uniformed Services University of the Health Sciences (USUHS).
- Employees of public school systems organized by Indian tribal governments.
- Certain ministers

Ministers. The following ministers are eligible employees for whom a 403(b) account can be established:

1. Ministers employed by Section 501(c)(3) organizations.
2. Self-employed ministers. A self-employed minister is treated as employed by a tax-exempt organization that is a qualified employer.
3. Ministers (chaplains) who meet both of the following requirements:
   a) They are employed by organizations that are not Section 501(c)(3) organizations.
   b) They function as ministers in their day-to-day professional responsibilities with their employers.

Example: A minister employed as a chaplain by a state-run prison and a chaplain in the United States Armed Forces are eligible employees because their employers are not Section 501(c)(3) organizations and they are employed as ministers.

Who Can Set Up a 403(b) Account?

An employee cannot set up his own 403(b) account. Only employers can set up 403(b) accounts. A self-employed minister cannot set up a 403(b) account for his benefit. Only the organization (denomination) with which the minister is associated can set up an account for the minister's benefit.

How Are Contributions Made to a 403(b) Account?

Generally, only the employer can make contributions to an employee's 403(b) account. However, some plans will allow the employee to make after-tax contributions.

The following types of contributions can be made to 403(b) accounts:

- *Elective deferrals.* These are contributions made under a salary reduction agreement. This agreement allows the employer to withhold money from the employee's paycheck to be contributed directly into a 403(b) account for the employee's benefit. Except for Roth contributions, the employee does not pay income tax on these contributions until withdrawn from the account. If the contributions are Roth contributions, the employee pays taxes on the contributions but any qualified distributions from the Roth account are tax-free.

- *Nonelective contributions.* These are employer contributions that are not made under a salary reduction agreement. Nonelective contributions include matching contributions, discretionary contributions, and mandatory contributions from the employer. An employee does not pay income tax on these contributions until withdrawn from the account.

- *After-tax contributions.* These are contributions (that are not Roth contributions) made with funds that the employee must include in income on his tax return. A salary payment on which income tax has been withheld is a source of these contributions. If the plan allows employees to make after-tax contributions, they are not excluded from income and cannot be deducted on the employee's tax return.

A combination of any of the three contribution types listed above is allowed.

Self-employed minister. A self-employed minister is considered both an employee and an employer, and can contribute to a retirement income account for his own benefit.

How Much Can Be Contributed to a 403(b) Account?

There is a limit on the total contributions that can be made to an employee's 403(b) account each year. If contributions made to the 403(b) account are more than these contribution limits, penalties may apply.

Generally, contributions to a participant's 403(b) account are limited to the lesser of:

- The limit on annual additions or
- The limit on elective deferrals.

Depending upon the type of contributions made to the 403(b) account, only one of the limits may apply.

Limit on annual additions. This is a limit on the total contributions (elective deferrals, nonelective contributions and after-tax contributions) that can be made to a participant's 403(b) account. The limit on annual additions generally is the lesser of:

- $49,000 for 2010 or
- 100% of the employee's includible compensation for the most recent year of service.

Special rules apply if the employee has more than one 403(b) account or participates in a qualified plan.

Limit on elective deferrals. This is a limit on the amount of contributions that can be made to an account through a salary reduction agreement. Under the general limit on elective deferrals, the most that can be contributed to a participant's 403(b) account through a salary reduction agreement is $16,500 for 2010.

Special rules apply if the employee has more than one 403(b) account, another retirement plan or has more than 15 years of service with certain types of organizations.

Catch-up contributions. The most that can be contributed to the employee's 403(b) account is the lesser of the limit on annual additions or the limit on elective deferrals. If the employee will be age 50 or older by the end of the year, he may also be able to make additional catch-up contributions (up to $5,500 for 2010). These additional contributions cannot be made with after-tax employee contributions.

Designated Roth Accounts

A 401(k) plan may include designated Roth accounts (DRAs) as part of the plan. Unlike traditional contributions (which are excluded from the employee's taxable income), DRAs are currently includible in gross income. However, a qualified distribution of designated Roth contributions (and related earnings) is free of federal income tax.

Roth 401(k) (or DRA) contributions are elective contributions that are:

- Irrevocably designated by the employee at the time of the deferral election as Roth contributions,
- Treated by the employer as wages and included in the employee's income at the time of deferral and
- Maintained by the plan in a separate account.

To take advantage of DRAs, they must be provided for in the plan document. Additional Roth 401(k) guidance is contained in Regulation Sections 1.402A-1 and -2. Roth-designated contributions are generally subject to all of the same requirements that apply to regular pretax 401(k) deferral contributions. The funds must be maintained in separate accounts that can be rolled over to either a Roth IRA or another qualified plan that allows for Roth contributions. Roth 401(k) accounts are subject to the required minimum distribution rules.

Roth 401(k) accounts will generally be more advantageous than regular Roth IRAs because:

- There is no income limit that would restrict a plan participant from making a Roth 401(k) deferral, which would make them attractive to higher income individuals.

- Larger contributions can be made to a Roth 401(k) [up to $16,500 for all Roth 401(k) contributions and regular 401(k) elective deferrals in 2010; $22,000, if age 50 or older], which is advantageous to both higher and lower income individuals.
- Pretax matching contributions can be made by an employer on contributions to a designated Roth account.

Plans must be amended and this is a voluntary change. Before they can accept Roth contributions, 401(k) plans must be amended to allow for separate tracking of the Roth contributions. However, plans don't have to allow Roth contributions. In that situation, there's no requirement to add the Roth provisions in order to retain the plan's qualified status.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Stella is an employee of MegaCo, a for-profit entity. She elects to have part of her biweekly, pre-tax compensation contributed to the company's profit-sharing plan. MegaCo makes matching contributions to the plan on Stella's behalf. This is an example of what type of plan?

    a. 401(k) plan.

    b. Automatic enrollment 401(k) plan.

    c. 403(b) plan.

    d. Designated Roth account (DRA).

12. Bluebonnet Company (BC) has a 401(k) plan. Under which of the following circumstances, would the plan be considered to meet the nondiscrimination rules?

    a. The actual deferral percentage (ADP) for highly compensated individuals (HCEs) is 250% of the ADP for nonhighly compensated individuals (NHCEs).

    b. The actual contribution percentage (ACP) for the eligible HCEs is 125% of the ACP for the group of NHCEs.

    c. The aggregate amount of the plan accounts of key employees is 65% of that of all employees participating in the plan, and BC contributes 2% of compensation for all non-key employees.

    d. BC makes top-heavy calculations for key employees who are officers that make $170,000 or more in 2010.

13. Which of the following scenarios regarding 403(b) accounts is correct?

    a. Robert, a self-employed minister, sets up his own 403(b) account.

    b. Caroline, age 33, makes $100,000 annually. The total of her 403(b) contributions for 2010 is $50,000.

    c. Elliot, age 40, makes $16,000 of salary reduction contributions into his 403(b) account in 2010.

    d. Sarah, age 55, makes after-tax catch-up contributions to her 403(b) account.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Stella is an employee of MegaCo, a for-profit entity. She elects to have part of her biweekly, pre-tax compensation contributed to the company's profit-sharing plan. MegaCo makes matching contributions to the plan on Stella's behalf. This is an example of what type of plan? **(Page 63)**

    a. **401(k) plan. [This answer is correct. A *401(k) plan* is a type of profit-sharing or stock bonus plan to which employees can choose to have part of their compensation contributed on a before-tax basis instead of receiving the compensation in cash. This contribution is called an *elective deferral* because participants choose (elect) to set aside the money. When the 401(k) plan is part of a profit-sharing plan, employers still have the advantage of flexibility in making discretionary contributions. The plan that Stella makes contributions to in this scenario fits this definition of a 401(k) plan.]**

    b. Automatic enrollment 401(k) plan. [This answer is incorrect. An automatic enrollment 401(k) plan allows an employer to automatically enroll employees and place deductions from their salaries in certain default investments, unless the employee elects otherwise. Because Stella elected to enroll in MegaCo's plan, this is not an automatic enrollment 401(k) plan.]

    c. 403(b) plan. [This answer is incorrect. A *403(b) plan*, also known as a *tax-sheltered annuity (TSA) plan*, is a retirement plan for certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers. 403(b) plans can be annuity contracts, custodial accounts, or retirement income accounts set up for church employees. Because Stella works for a for-profit company, the company would not be able to set up a 403(b) plan for its employees.]

    d. Designated Roth account (DRA). [This answer is incorrect. A 401(k) plan may include DRAs as part of the plan. DRAs are currently includible in gross income. Because Stella was contributing pre-tax funds, she was not contributing to a DRA.]

12. Bluebonnet Company (BC) has a 401(k) plan. Under which of the following circumstances, would the plan be considered to meet the nondiscrimination rules? **(Page 71)**

    a. The actual deferral percentage (ADP) for highly compensated individuals (HCEs) is 250% of the ADP for nonhighly compensated individuals (NHCEs). [This answer is incorrect. If these circumstances exist, BC has failed the ADP test. The ADP test is met if the ADP for the eligible HCEs does not exceed the greater of (1) 125% of the ADP for the group of NHCEs or (2) the lesser of 200% of the ADP for the group of NHCEs or the ADP for the group of NHCEs plus 2%.]

    b. **The actual contribution percentage (ACP) for the eligible HCEs is 125% of the ACP for the group of NHCEs. [This answer is correct. One nondiscrimination test 401(k) plans must meet is the ACP test. The ACP test is met if the ACP for eligible HCEs does not exceed the greater of (1) 125% of the ACP for the group of NHCEs or (2) the lesser of 200% of the ACP for the group of NHCEs or the ACP for the group of NHCEs plus 2%. BC has passed the ACP test under these circumstances; therefore, unless it fails in some other way, BC's plan would meet the nondiscrimination rules.]**

c. The aggregate amount of the plan accounts of key employees is 65% of that of all employees participating in the plan, and BC contributes 2% of compensation for all non-key employees. [This answer is incorrect. Under these circumstances, BC's plan fails the top-heavy test. A plan is top-heavy when, as of the last day of the preceding plan year, the aggregate value of the plan accounts of key employees exceeds 60% of the aggregate value of the plan accounts for all employees under the plan. If a 401(k) plan is top-heavy, the employer must contribute up to 3% of compensation for all non-key employees still employed on the last day of the plan year.]

d. BC makes top-heavy calculations for key employees who are officers that make $170,000 or more in 2010. [This answer is incorrect. One method of testing for a key employee is by salary. For 2010, a key employee is an employee who, at any time during the plan year, was an officer whose annual compensation from the employer exceeds $160,000 (for 2010).]

13. Which of the following scenarios regarding 403(b) accounts is correct? **(Page 77)**

a. Robert, a self-employed minister, sets up his own 403(b) account. [This answer is incorrect. An employee cannot set up his own 403(b) account. Only employers can set up 403(b) accounts. A self-employed minister cannot set up a 403(b) account for his benefit. Only the organization (denomination) with which the minister is associated can set up an account for the minister's benefit.]

b. Caroline, age 33, makes $100,000 annually. The total of her 403(b) contributions for 2010 is $50,000. [This answer is incorrect. There is a limit on the total contributions that can be made to a participant's 403(b) account. The limit on annual additions generally is the lesser of (1) $49,000 for 2010 or (2) 100% of the employee's includible compensation for the most recent year of service.]

c. Elliot, age 40, makes $16,000 of salary reduction contributions into his 403(b) account in 2010. [This answer is correct. There is a limit on the amount of contributions that can be made into an account through a salary reduction agreement. Under the general limit on elective deferrals, the most that can be contributed to a participant's 403(b) account through a salary reduction agreement is $16,500 for 2010.]

d. Sarah, age 55, makes after-tax catch-up contributions to her 403(b) account. [This answer is incorrect. If an employee will be age 50 or older by the end of the year, he may be able to make additional catch-up contributions. These additional contributions cannot be made with after-tax employee contributions.]

EXAMINATION FOR CPE CREDIT

Lesson 5

Determine the best answer for each question below. Then log on to our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

11. Which of the following companies meets one of the requirements to qualify its plan as a 401(k) plan under IRC Sec. 401(k)?

    a. Company A allows all employees to contribute a maximum of $22,000 to the plan in 2010.

    b. Company B considers salary deferrals to its plan as only 50% vested during the first year of employment.

    c. Company C allows all employees to defer salary to the plan after reaching one year of service.

    d. Company D allows employees age 40 and above to make special catch-up contributions to the plan.

12. Dean, an employee of Whammy Inc. is 55 years old. His total annual salary is $50,000. He elects to contribute the maximum amount possible to the company's 401(k) plan in 2010. Whammy also contributes the maximum percentage profit sharing contribution to the plan on his behalf. Finally, Whammy will match Dean's contributions up to 3% of compensation. What is the total amount contributed for Dean in 2010?

    a. $14,000.

    b. $22,000.

    c. $36,000.

    d. $49,000.

13. List all of the following employees who would be eligible to participate in a 403(b) plan.

    Martha is employed by a Section 501(c)(3) plan.

    Tom is employed by a public school system, but does not participate in its day-to-day operations.

    Grace is employed by a private hospital.

    Jeff is a self-employed minister.

    Arnold is a chaplain in a prison run by the state.

    a. Martha and Grace.

    b. Martha, Jeff, and Arnold.

    c. Tom, Jeff, and Arnold.

    d. Tom, Grace, Jeff, and Arnold.

Lesson 6: Distributions

Learning Objectives

Completion of this lesson will enable you to:

- Determine when IRA and qualified plan distributions are allowed, when they are required, how much is taxable, and when penalties apply to the distribution.

IRA Distributions

Note: This section covers distributions from traditional IRAs, SEPs and SIMPLE IRAs.

When Can IRA Distributions Be Withdrawn?

IRA assets can be withdrawn or used at any time (although a 10% additional tax generally applies if the funds are withdrawn or used before the owner reaches age 59½). The owner must begin receiving distributions from the IRA once he reaches his required beginning date.

IRA contributions returned. A tax-free withdrawal of IRA contributions can be made before the due date (plus extensions) for filing the tax return for the year in which the contributions were made (in which case, the 10% tax on early distributions should not apply). For a contribution withdrawn to be tax-free, both of the following must apply:

- No deduction was taken for the contributions, and
- Any interest or other income earned on the contribution is withdrawn. Any loss on the contribution while it was in the IRA can be taken into account 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.

Although the IRA contribution can be withdrawn tax-free, any earnings on the contribution withdrawn must be included in income. The earnings should be included in income for the year in which the contributions were made, not the year in which they were withdrawn.

Caution: Except for any part of a withdrawal that is a return of nondeductible contributions (basis), any withdrawal of the contributions after the due date (including extensions) of the return generally will be treated as a taxable distribution.

Special rules for SIMPLE IRAs. SIMPLE IRAs generally are subject to the same distribution rules as traditional IRAs, except that special rollover and early distribution tax rules apply to SIMPLE IRA distributions made during the two-year period beginning on the day the employee first participates in any SIMPLE IRA plan maintained by the employer. An employee begins participating in a SIMPLE IRA plan on the day the employer first deposits contributions to the employee's SIMPLE IRA

How Can Distributions Be Made?

Distribution options for traditional IRAs are usually more flexible than those offered under most qualified plans. Distributions generally can be made at any time and in any amount at the IRA owner's demand, subject to the requirements or penalties imposed by the IRA custodian. Thus, distributions may be made in installments (equal or unequal), or the entire account may be

distributed in a lump sum. However, distributions made before the owner reaches age 59½ may be subject to the 10% early distribution penalty.

IRAs are not subject to the survivor annuity rules or the spousal consent rules that apply to qualified plans. Thus, distributions can be made entirely at the IRA owner's discretion without spousal consent. However, a divorce decree may require the sharing of the IRA proceeds with a divorced spouse. Furthermore, state or local laws may provide certain spousal rights, such as community property rights.

Traditional IRAs are subject to the required minimum distribution rules, which require that distributions begin no later than April 1 of the calendar year following the year in which the IRA owner reaches age 70½. The provision that allows certain qualified plan participants to delay their required beginning date until retirement does not apply to IRA owners.

Only the surviving spouse may roll over the IRA proceeds at the IRA owner's death and treat the IRA as his or her own. However, nonspouse beneficiaries have an opportunity to make nontaxable transfers into an inherited IRA (opened in the deceased owner's name).

How IRA Distributions Are Taxed

Distributions from an IRA (other than a Roth IRA) are taxed as ordinary income in the year received (except for the portion that represents a return of nondeductible contributions). *Exceptions:*

- Rollovers.
- Tax-free withdrawals of contributions

Qualified charitable distributions. For years 2006–2009, individuals over age 70½ could make qualified charitable distributions (QCDs) directly from their IRAs to a qualified public charity. QCDs (which were limited to $100,000 per individual per year) were neither included in the individual's income nor allowed as a charitable deduction. However, QCDs were a tax-efficient means of making charitable donations because the transfer did not increase the individual's AGI, which was advantageous for the taxation of certain AGI-sensitive items (such as taxable social security benefits or deductions allowed only to the extent they exceed a percentage of AGI). Tax professionals should watch for possible tax legislation that would extend this expired provision.

Lump-sum distributions. Unlike qualified retirement plans, a lump-sum distribution (LSD) from an IRA is not eligible for 10-year averaging or capital gain treatment. However, eligible distributions from a "conduit IRA" can be rolled over to a qualified plan if the plan permits. Thus, the tax benefits available for LSDs may be available if the IRA funds were received from one qualified plan and then rolled over to another qualified plan, as long as the rollover to the qualified plan was through a conduit IRA.

Nondeductible contributions. If nondeductible contributions were made or any after-tax amounts were rolled over to a traditional IRA, the cost basis (investment in the contract) will be the amount of those contributions. These nondeductible contributions are not taxed when distributed; instead, they are a return of investment in the IRA.

Note: Individuals can contribute to a SEP IRA. Their contributions (other than employer contributions made by a self-employed individual) are treated as traditional IRA contributions and may be deductible or nondeductible.

Only the part of the distribution that represents nondeductible contributions and rolled-over after-tax amounts (the cost basis) is tax-free. If there is cost basis in any traditional IRA, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings and gains (if any). Until all of the cost basis has been distributed, each distribution is partly nontaxable and partly taxable. If an individual has cost basis in a traditional or SEP IRA, Form 8606 (*Nondeductible IRAs*) must be completed and attached to the tax return if distributions are received from a traditional, SIMPLE or SEP IRA. This form will figure the nontaxable distributions for the current year, as well as the total IRA basis for the current and prior years.

The nontaxable portion of current-year non-Roth IRA distributions is calculated as follows:

$$\frac{\text{Total basis}}{\text{Traditional, SIMPLE and SEP IRA combined account balance at year-end} + \text{Amount distributed during the year} + \text{Outstanding rollover*}} \times \text{Traditional, SEP, SIMPLE IRA distributions} = \text{Nontaxable portion of IRA distributions}$$

* Outstanding rollover means any amounts distributed before year-end but rolled into another IRA in the following year under the 60-day rollover rule.

When calculating the amount of nontaxable distributions, the total FMV of all the individual's traditional IRAs (including SEP IRAs, SIMPLE IRAs and IRAs containing funds rolled over from a qualified plan, but not Roth IRAs) must be included in the fraction's denominator. The taxpayer cannot use only the IRA from which the distributions were received. The FMV of all IRAs at year-end includes both realized and unrealized appreciation of IRA assets.

Example: Tommy, age 60, has two traditional IRAs, one at National Bank and the other at State Bank. He has made $3,000 of contributions (all were deductible) to the National Bank IRA and $5,000 (none were deductible) to the State Bank IRA. During 2010, he took a $4,000 distribution from the State Bank IRA. As of December 31, 2010, the FMV of the National Bank IRA was $9,000, and the FMV of the State Bank IRA was $3,000 (after being reduced by his $4,000 distribution).

Although all of Tommy's 2010 distribution was from the State Bank IRA (to which only nondeductible contributions were made), both traditional IRAs must be included in the calculation. Thus, the nontaxable portion of his distribution is calculated as follows:

$$\frac{\$5{,}000}{\$9{,}000 + \$3{,}000 + \$4{,}000} \times \$4{,}000 = \$1{,}250$$

Of the $4,000 distribution, $1,250 of the distribution is a tax-free return of basis; the remaining $2,750 is taxable income.

Note: If Tommy's distribution came from the National Bank IRA, the results would be the same (assuming the combined value of the IRAs does not change). If a taxpayer has at least one traditional IRA with tax basis, distributions from traditional IRAs will include a return of basis, regardless of which traditional IRA they came from.

Reporting and Withholding Requirements for Taxable Distributions

Distributions received from a traditional IRA are reported on Form 1099-R or a similar statement. IRA distributions are shown in boxes 1 and 2a of Form 1099-R. A number or letter code in box 7 indicates what type of distribution was received from the IRA.

Federal income tax is withheld from distributions from traditional IRAs unless the owner chooses not to have tax withheld by submitting Form W-4P to the payer. The amount of tax withheld from an annuity or a similar periodic payment is based on the owner's marital status and the number of withholding allowances claimed on Form W-4P. Generally, tax will be withheld at a 10% rate on nonperiodic distributions.

Distribution Rules By Age		
Age at December 31	**Distribution Required?**	**Early Distribution Penalty Apply?**
Under 59½	No	Yes, 10%[1] unless exception applies.
Over 59½ but under 70½	No	No
70½ and older	Yes[2]	No

[1] 25% penalty if SIMPLE plan distribution made less than two years from when taxpayer first participated in the plan.

[2] Required minimum distributions generally must start for the year account owner reaches age 70½ (but the RMD for that year can be delayed to April 1 of the following year).

Qualified Plan Distributions

Note: This section covers distributions from qualified plans, such as 401(k), profit-sharing and money purchase pension plans.

When Can Distributions Begin?

The qualified plan must provide that, unless the plan permits and the participant elects otherwise, the payment of benefits will begin no later than the 60th day after the close of the plan year in which the latest of the following occurs:

- The participant reaches the earlier of age 65 or the plan's normal retirement age
- The participant completes 10 years of plan participation.
- The participant terminates service with the employer.

Election to postpone distributions. A plan may permit a participant to elect to postpone the start of benefit payments beyond the date defined above. If this election is permitted, it must be made by submitting to the plan administrator a signed statement describing the benefit and the date on which payment is to start.

Caution: Participants can't postpone the start of benefit payments beyond their required beginning date under the required minimum distribution rules.

Earlier distributions may be allowed. The requirements for when distributions must begin do not prevent an earlier payout of benefits. Small employer plans typically allow participants to receive distributions when they terminate employment. Pension plans, including defined benefit, cash balance, money purchase and target benefit plans, can also make distributions under certain circumstances. However, 401(k) plans cannot permit distributions of elective deferrals prior to age 59½ if the participant is still employed with the company sponsoring the plan, except in the event of hardship.

Caution: Participants who receive distributions before age 59½ may be subject to the 10% early distribution penalty tax.

Available Forms of Distribution

The employer's retirement plan document generally specifies which forms of benefit distribution are available to a participant upon retirement or termination from employment (other than death). Depending on the plan and participant's election, retirement benefits may be distributed in the form of:

- An annuity (periodic payments for a period of time greater than one year) or
- A lump-sum distribution.

Distribution method determined by type of plan. Qualified plans are of two types—*defined benefit* and *defined contribution plans*, and the type of plan determines what form of distribution is available.

Defined benefit plans:

- Must offer a qualified joint and survivor annuity (QJSA) as the normal form of benefit distribution.
- Other types of annuities and lump-sum distributions may be offered at the participant's election and spouse's consent.

Defined contribution plan:

- Most offer lump-sum distribution options to participants, although such distributions may be subject to the spousal consent rules.
- Annuity options may also be offered.
- Certain plans must offer QJSAs as the normal form of benefit.

Choosing Between a Lump-Sum Distribution and Annuity

Choosing a distribution option involves considerations as to the participant's income tax and financial situations as well as naming the designated beneficiary. The participant's needs during retirement and the surviving spouse's needs in the event of the participant's death should be estimated. Planning should also consider how the distributions will impact the participant's children or grandchildren, if applicable.

Loans Treated as Distributions

Unless certain requirements are met, loans from qualified plans are deemed distributions, which can be subject to income tax, as well as the 10% early distribution penalty tax.

Required Minimum Distributions

How the RMD Rules Work

The required minimum distribution (RMD) rules limit the time retirement plan assets can grow tax-deferred by forcing qualified plan participants and IRA owners to begin taking plan distributions no later than their required beginning date.

Observation: The RMD rules do not apply to Roth IRAs until the account owner dies. This is a significant advantage of the Roth IRA for individuals who plan to accumulate wealth in their retirement plans to pass to their heirs.

Note: The terms *owner* and *participant* are used interchangeably for both IRAs and qualified plans throughout this discussion.

Caution: If the annual distribution is less than the RMD, the shortfall is subject to a 50% excise tax.

Multiple distributions allowed. The annual RMD can be taken in more than one payment as long as the total distributions for the year are at least as much as the required amount.

Multiple accounts. The RMD must be calculated separately for each qualified plan and IRA.

- *Qualified plans*—The RMD determined for each plan must be distributed from that plan.
- *IRAs.*
  - The RMDs for each IRA may be totaled, and the total may be distributed from any one or more IRAs. However, only amounts in IRAs that an individual holds as the IRA owner may be aggregated.
  - Amounts in IRAs that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in IRAs that the individual holds as the IRA owner or as the beneficiary of another decedent.
  - Required distributions from inherited Roth IRAs are calculated separately from all other IRAs. In other words, the RMD from a taxpayer's Roth IRA cannot be made from a traditional IRA, or vice versa.

Distributions total more than RMD. If, in any year, the taxpayer receives more than that year's RMD, he cannot apply the excess against the RMD required for the next or any future tax year. (*Exception:* Any amount distributed in the year the taxpayer turns age 70½ counts toward the amount that must be distributed by April 1 of the following year.)

Waiver of 2009 RMDs

The RMD for 2009 was waived for IRAs and defined contribution plans, including profit sharing, 401(k), 403(b) and state-sponsored 457 plans. RMDs from defined benefit plans were not waived.

Taxpayers who reached age 70½ in 2009. Under the normal rules, these taxpayers would have until April 1, 2010 to take their first RMD. But, since that distribution pertains to 2009, it is waived. However, a 2010 RMD will be required no later than December 31, 2010.

Example: Alex reached age 70½ in 2009. His first RMD (for 2009) would normally be required no later than April 1, 2010. However, since 2009 RMDs are waived, Alex will not have to take the 2009 distribution. However, he is required to take a 2010 RMD by December 31, 2010.

When Must RMDs Begin?

Required beginning date—IRAs. Annual RMDs from traditional IRAs, SIMPLE IRAs and SEPs must begin by the year the taxpayer reaches age 70½. This is referred to as the *required beginning date* (RBD). Taxpayers can choose to delay receipt of the first distribution until April 1 of the year following the year they turn 70½. Thereafter, the RMD for each year must be made by December 31. If the first distribution is delayed until April 1 of the following year, the second distribution must be made by December 31 of that year.

Required beginning date—qualified plans. A qualified plan is not subject to the RMD rules until the year the participant retires, even if over age 70½. However, this RMD exception doesn't apply to participants who are more-than-5% owners of the business sponsoring the qualified plan.

Caution: The delayed RBD for employees who continue to work after age 70½ does not apply to SEPs and SIMPLE IRAs.

Calculating RMDs during the Participant's Life

The RMD for each calendar year is the account balance on December 31 of the preceding year divided by the applicable distribution period from the *Uniform Lifetime Table* (Table III of Appendix C in Pub. 590), for the participant's age at the end of the distribution year.

Example: Carter and Ann each have an IRA valued at $90,000 on December 31, 2009. Carter was born on September 5, 1939. Ann was born on March 5, 1940. Both reach age 70½ in 2010. Carter will be 71 at the end of 2010; Ann will be 70. Their required minimum distributions for 2010 are:

Carter .... $90,000 ÷ 26.5 = $3,396

Ann.................................. $90,000 ÷ 27.4 = $3,285

Exception: If the owner's sole beneficiary at all times during the year is a spouse more than 10 years younger than the owner, use the distribution period from the Joint and Last Survivor Table in the IRS Publication 590 (Table II of Appendix C) for a smaller RMD.

Determining the account balance. The account balance used in computing the RMD for any distribution year is normally the value as of December 31 of the preceding calendar year.

Exception: The first RMD is based on the account balance as of December 31 of the year before the individual turns age 70½ (or, if applicable for qualified plans, retires) even though the distribution does not have to occur until April 1 of the next year.

Account balance adjustments. The account balance must be adjusted for contributions and forfeitures made after the valuation that were attributable to the prior distribution year. If a rollover from a retirement plan or IRA is pending on December 31 (distribution was made but the funds did not reach the receiving IRA), the account balance of the receiving plan should be increased by the rollover amount.

RMDs continue to be calculated using these rules through the year of the participant's death. Beginning in the year after the participant's death, any remaining plan assets must be distributed under the post-death rules.

Caution: If any amount of an RMD is not timely distributed, the excess accumulation is subject to a 50% penalty.

Calculating RMDs after the Participant's Death—General Rules

The RMD rules also determine how quickly a participant's account must be paid out after his death. Different rules apply, depending on whether the participant dies before or after his RBD and whether there is a designated beneficiary.

Year of death. The RMD for the year an account owner dies is calculated under the rules for lifetime distributions as if the owner had lived the entire year. The beneficiary must take the owner's RMD by year-end if the owner died before taking the distribution. If the owner died before reaching his RBD for distributions, no distribution is required in the year of death.

Note: The rules for post-death distributions apply starting in the year after the year of the account owner's death.

Designated beneficiaries. A beneficiary is generally the person or entity whom the retirement account owner names as beneficiary, usually on the form provided by the administrator or trustee. However, only individuals and certain trusts qualify as *designated beneficiaries*. Although a charity or the owner's estate can be named as a beneficiary, these entities are not designated beneficiaries for the RMD rules.

The date for determining beneficiaries is September 30 of the year following the year of the deceased participant/owner's death. If there is a beneficiary that does not qualify as a designated beneficiary as of September 30 of the calendar year after the year of the owner's death, RMDs are made as if there were no designated beneficiary.

Note: Normally, a nonindividual, such as a charity, trust or an estate, cannot be considered a designated beneficiary. However, if the beneficiary is a *qualified trust*, the trust is "looked-through" to treat the trust beneficiaries as designated beneficiaries. In that case, the oldest trust beneficiary's age is used to compute the post-death RMDs, unless the five-year rule is used.

Multiple beneficiaries. If there are multiple beneficiaries, all beneficiaries must be individuals or qualifying trusts or the owner is considered to have no designated beneficiary. When there are multiple individual beneficiaries for one account, distributions are based on the life of the oldest beneficiary

No beneficiary named. If the owner fails to name a beneficiary, the document may provide a default provision designating a certain person, such as the owner's spouse, as the beneficiary.

Five-year rule. Under this rule, the entire account must be distributed by the end of the fifth year after the year the account owner dies. No distribution is required for any year before that fifth year.

Practice Tip: Because the 2009 RMD was waived, 2009 is not counted for RMDs made using the five-year rule. In effect, the five-year period is extended for one year if the five-year period includes 2009.

Example: Rose died in 2007. If her beneficiaries are using the five-year rule to satisfy the post-death RMD rules, the entire balance of her account would normally have to be distributed by December 31, 2012. However, due to the waiver of the 2009 RMD, the account now must be distributed by December 31, 2013.

The five-year rule can be used any time the account owner dies before the RBD. However, it is mandatory if the owner dies before the RBD and any beneficiary is not a designated beneficiary (for example, the beneficiary is the decedent's estate or a charity).

Note: Qualified plans are not required to offer all pay-out options allowed under these rules. A plan can mandate the five-year rule when death occurs before the RBD, even when there is a named beneficiary. A plan can also require a lump-sum payment even though the five-year rule is authorized under tax law. In that case, transferring the assets into an IRA may permit a longer distribution period.

Life expectancy rule. If the account owner dies on or after the RBD, post-death RMDs must continue as before death, except, if there is a designated beneficiary, they can be made over that beneficiary's life expectancy, if longer than the decedent's.

Post-death RMDs can also be made over a designated beneficiary's life expectancy if the account owner dies before the RBD, as long as distributions begin by December 31 of the year after the account owner dies.

Practice Tip: The waiver of the 2009 RMD applied to any post-death RMD for 2009 computed under the life expectancy rule.

Other rules:

- The RMD must be calculated separately for each inherited IRA or qualified plan. If the deceased owner had multiple IRAs with the same beneficiary, the total distribution from those IRAs can be taken from any one or more of the decedent's IRAs. The RMD for the owner's own IRAs cannot be withdrawn from the inherited IRAs or vice versa.
- If the total distribution for a year is greater than the RMD for that year, the excess amount distributed will not count as part of the RMD for the following year.

Calculating RMDs—Death Occurs Before the RBD

If the participant dies before the RBD (or at any age for Roth IRA owners), the rules for how quickly an inherited qualified plan or IRA must be withdrawn vary, depending on whether the participant/owner had a designated beneficiary and who that designated beneficiary was.

Surviving spouse as beneficiary. If the participant dies before his RBD and the surviving spouse is the sole designated beneficiary, the surviving spouse can defer distributions until the later of:

- December 31 of the year after the year in which the participant died or
- December 31 of the calendar year in which the participant would have reached age 70½.

At that time, RMDs must be paid over the surviving spouse's life expectancy.

Regardless of when the participant dies, the surviving spouse can either roll over eligible rollover distributions from the decedent's qualified plan to an IRA or into his or her own qualified plan. Also, the surviving spouse can elect to treat the decedent's IRA as his or her own. In either situation, the RMD rules apply as though the surviving spouse were the owner rather than the beneficiary. That is, distributions must begin when the surviving spouse attains age 70½ and lifetime RMDs are then determined using the life expectancy from the Uniform Lifetime Table (rather than the surviving spouse's single life expectancy).

Example: John dies in July 2009 at age 63. His wife, Jeanie, who is age 55 when John dies, is the designated beneficiary of his retirement plan. As the surviving spouse, Jeanie can postpone receiving John's interest until December 31, 2016, the year John would have attained age 70½. At that time, Jeanie must begin taking RMDs over her life expectancy, using the Single Life Table, based on her age as of December 31 each year.

Alternatively, Jeanie could either roll the proceeds into her own IRA or qualified plan or elect to treat John's IRA as hers, thus postponing the RMDs until her RBD.

If the surviving spouse chooses not to roll over the deceased spouse's qualified plan or IRA into his own (and no election is made to treat the IRA as his own), the applicable distribution period for each year is taken from the *Single Life Table* (Table I of Appendix C in Pub. 590) for the surviving spouse's age at the end of the distribution year.

Example: Jane's husband died in 2009 at the age of 65. Jane is 63 at the end of 2010 and the sole beneficiary of his IRA. She chooses not to roll over the funds into her own IRA. Jane's RMDs are computed as follows:

2010: (December 31, 2009, account balance) ÷ 22.7

2011: (December 31, 2010, account balance) ÷ 21.8

2012: (December 31, 2011, account balance) ÷ 21.0, etc.

Nonspouse individual or qualified trust as beneficiary. If the participant dies before the RBD (or at any age for Roth IRA owners) and the designated beneficiary is not the participant's spouse, either the five-year rule or the life expectancy rule applies. The applicable distribution period for the year after the owner's death is taken from the *Single Life Table* for the beneficiary's age at the end of the year. The distribution period for each successive year is reduced by one for each year that has elapsed.

The plan may specify which of the two rules applies to distributions after the participant's death, or it may allow participants or beneficiaries to elect which rule applies. If the plan is silent as to which rule applies when no election has been made, distributions must be made under the life expectancy rule.

Observation: When the participant dies before his RBD, the life expectancy rule will be the default whenever there is a designated beneficiary, unless the plan provides for the five-year rule and it is elected.

Example: Helen dies in May 2010 at age 65. Her daughter, Diana, age 42 at the end of 2010, is the designated beneficiary of her IRA. The IRA document does not specify which payout period applies (the life expectancy rule or the five-year rule).

Unless she chooses the five-year rule, Diana must use the life expectancy rule and withdraw at least $19,656 by December 31, 2011. She determines this amount by dividing the IRA value as of December 31, 2010 ($800,000) by the factor of 40.7 from the *Single Life Table* for her age (43) as of December 31, 2011. Her RMD for 2012 will be based on the account value as of December 31, 2011 and a factor of 39.7 (40.7 reduced by one).

Alternatively, Diana may elect to have the entire IRA distributed to her on or before December 31, 2015 or transfer the account balance (minus the RMD if made in the year after Helen's death) over to an inherited IRA.

Multiple beneficiaries—death before RBD. If there are multiple beneficiaries (all individuals), they must receive distributions either:

- Over the oldest beneficiary's life expectancy, based on his age on his birthday in the year following the year of the participant's death or
- Under the five-year rule if the participant dies before the RBD.

Exception: If the beneficiaries established separate accounts payable to themselves by December 31 of the year after the participant's death, each individual may choose to take distributions under the five-year rule or the life expectancy rule, based on his own life expectancy.

No beneficiary or nonindividual as beneficiary. If the participant dies before his RBD and no beneficiary has been named, or if there is a beneficiary who is not an individual or a qualified trust on September 30 of the year after the participant's death, the participant is treated as having "no designated beneficiary." In that case, all benefits must be distributed under the five-year rule.

Example: Ingrid died in 2010 at age 67 (before her RBD) naming her estate beneficiary of her three IRAs. Because an estate is not considered a designated beneficiary, Ingrid's entire IRA balances must be distributed by the end of the fifth calendar year after her death. All of her IRAs must be distributed by December 31, 2015.

Hardship Distributions from 401(k) Plans

Employees generally cannot withdraw funds from a 401(k) until they leave the company. However, employees may qualify to withdraw 401(k) elective contributions before then if there is an immediate and heavy financial need.

Expenses that satisfy the financial need requirement:

- Medical expenses, including expenses not yet incurred.
- Purchase of principal residence.
- Tuition for postsecondary education (one full year's payment for the employee, spouse, children or dependents).
- To prevent eviction or to halt a mortgage foreclosure on the taxpayer's principal residence.
- Amounts to cover anticipated federal and state income taxes, plus early withdrawal penalties due to the hardship distribution.
- Cost of burial or funeral expenses for the employee, parent, child or other dependent.
- Certain expenses relating to the repair of damage to the employee's principal residence that qualify for the casualty loss deduction without regard to whether loss exceeds 10% of AGI.

Note: A plan that permits hardship distributions may include distributions for medical, tuition and funeral expenses for a primary beneficiary under the plan (even if not a spouse, child or dependent of the employee). In addition, a hardship of the employee's spouse or dependent is deemed to be a hardship of the employee.

Hardship withdrawals are subject to income tax and possibly the 10% early withdrawal penalty.

Tax on Early Distributions

When the 10% Penalty Tax Applies

If a taxpayer takes an early withdrawal from a qualified plan or IRA (traditional, SIMPLE or Roth) and does not roll over the full amount, the amount not rolled over generally is subject to a 10% (25% for certain withdrawals from a SIMPLE IRA) early distribution penalty. Early withdrawals are distributions of cash or property made before the taxpayer reaches age 59½. The 10% additional tax applies to the part of the distribution that must be included in gross income and is in addition to any regular income tax on that amount. Unless an exception applies, Form 5329 must be filed to report the early distribution and calculate the tax.

Caution: Early withdrawals from a SIMPLE IRA occurring during the two-year period following the date of initial participation in the plan are subject to a 25% tax, rather than 10%.

Example: Sophie, who is 39 years old, receives a $3,000 distribution from her traditional IRA. Sophie does not meet any of the exceptions to the 10% penalty tax, so the $3,000 is an early distribution. Sophie never made any nondeductible contributions to her IRA. She must include the $3,000 in her gross income for the year of the distribution and pay income tax on it. She must also pay a penalty tax of $300 (10% × $3,000), which is calculated on Form 5329.

When the 10% Penalty Tax Does Not Apply

The tax does not apply to any part of a distribution that is tax-free, such as amounts that represent a return of cost or that were rolled over. It does not apply to a distribution received by a taxpayer who is the beneficiary of a deceased owner/participant. It also does not apply to corrective distributions of excess contributions or excess deferrals.

Note: Distributions of employer stock from a qualified plan are subject to the 10% early distribution penalty (if the taxpayer is under age 59½ on the distribution date) based only on the cost basis of the shares (to the extent this basis is currently taxable), rather than the FMV of the stock.

Distributions Attributable to Disability

Distributions before an individual turns age 59½ are exempt from the penalty tax if they are attributable to his being disabled. An individual is considered disabled if he can furnish proof that he cannot do any substantial gainful activity because of his physical or mental condition. A physician must determine that his condition can be expected to result in death or to be of long, continued and indefinite duration.

Substantial gainful activity means the activity, or a comparable activity, in which the individual customarily engaged before the disability arose (or before retirement if the individual was retired when the disability arose).

An impairment that can be corrected is not a disability for this purpose. An individual is not disabled if, with reasonable effort and safety, the impairment can be diminished to the point where it will not prevent him from engaging in his customary or any comparable substantial gainful activity.

Qualified Plan Distributions after Age 55

Qualified plan distributions received after the participant reaches age 55 and separates from service are not subject to the penalty tax. This exception is only available if the plan allows distributions before normal retirement age.

This exception applies only to participants who separate from service during or after the year they reach age 55. Therefore, a participant who retires before the year he turns 55, but waits until after age 55 to receive retirement plan benefits is subject to the tax on plan distributions received before age 59½ unless another exception applies.

Caution: Because this exception depends on the participant *separating from service* it does not apply to self-employed individuals (who generally cannot separate from service). It also does not apply to distributions from IRAs. Thus, the exception does not apply to SEP or SIMPLE IRA distributions since those plans are funded with IRAs established for the employee.

Example: At age 57, Walter takes early retirement. He participated in his employer's qualified plan and also has an IRA. He will receive monthly qualified plan distributions and wants to supplement this income with IRA distributions until he begins receiving social security.

The qualified plan distributions are not subject to the early distribution tax because Walter retired (that is, separated from service) after reaching age 55. However, the IRA distributions before age 59½ are subject to the 10% tax unless they are structured to meet the substantially equal payments (or another) exception.

Substantially Equal Periodic Payments

A payment received before the participant reaches age 59½ is not subject to the penalty tax if it is one of a series of substantially equal periodic payments (SEPPs).

This exception applies to IRA and qualified plan distributions regardless of the participant's age. However, qualified plan distributions are excepted from the 10% penalty tax only if the participant has separated from service.

What are substantially equal periodic payments? The payments must be computed based on the individual's life expectancy or the joint life expectancies of the individual and his designated beneficiary and be made at least annually.

There are three safe harbor methods for satisfying the "substantially equal periodic payment" exception to the 10% penalty (the required minimum distribution, fixed amortization or fixed annuitization method). Once the method is chosen and the series of payments is started, payments must continue until the later of five years or when the taxpayer reaches age 59½. If the substantially equal payments are changed or stopped before the required period ends, the taxpayer must pay the penalty tax and interest beginning with the tax year the penalty would have been payable and ending on the actual payment date.

Distributions made under the SEPPs exception do not need to actually continue for the individual's entire life. Payments may be altered (or stopped completely) after the later of:

1. The date the individual turns age 59½ or
2. The close of the five-year period beginning on the date the first payment was received.

Also, SEPPs that stop at the participant's death or disability are exempt from the tax if they met the criteria described above while the participant was living.

Caution: If SEPPs are modified or stopped before the specified date (except on account of death or disability), the 10% early distribution penalty tax is applied retroactively (recaptured) in the year the SEPPs are modified or stopped. In this case, the recaptured tax is the amount that would have been imposed on the current distribution and all previous distributions if the exception had never applied. The early distribution tax is applied only to the SEPPs received before the taxpayer turned 59½, even if the recapture event occurs after that date. Also, interest is charged from the tax year the distribution would have been subject to tax through the tax year the modification occurred.

Exception: The penalty tax is not recaptured if less than the amount computed is distributed because the account is depleted, as long as the taxpayer used an acceptable method of determining SEPPs up until that time.

Hardship Distributions

Many qualified plans do not allow distributions before the employee separates from service or reaches a certain age. However, premature distributions can be taken from certain qualified plans if the distributions are on account of certain events, such as disability, retirement or other immediate and heavy financial need. A hardship payout from a 401(k) plan is permissible for a primary beneficiary's hardship, and not just that of the account owner. The primary beneficiary does not have to be a dependent, and the purpose of the distribution can be the payment of certain specific expenses, such as medical expenses or tuition costs.

Caution: There is no exception to the 10% penalty for hardship distributions. But if such distributions are used to pay deductible medical or qualified education expenses, they may qualify for an exception to the 10% penalty.

Tax on Excess Accumulations

To ensure that most of the retirement benefits are paid to the participant or owner during his lifetime, rather than to his beneficiaries after his death, payments from an IRA (other than a Roth IRA) or qualified plan generally must begin no later than age 70½. If the actual distributions in any year are less than the RMD for that year, the participant (if living) or the beneficiary (after the participant's death) is subject to a 50% excise tax on the part of the RMD that was not distributed.

Lump-Sum Distributions from Qualified Plans

A lump-sum distribution from a qualified plan is eligible for special tax treatment. This special tax treatment is not available to lump-sum distributions from IRAs, however.

A lump-sum distribution is a distribution (or several distributions) of the plan participant's entire balance within a single tax year from all of the employer's qualified plans of one kind (pension, profit-sharing or stock bonus plans), paid for any of the following reasons:

- The plan participant has died,
- The participant reached age 59½,
- The participant, if an employee, separates from service or
- The participant, if a self-employed individual, became totally and permanently disabled.

Options for Lump-Sum Distributions

A taxpayer has four choices when a lump-sum distribution is received from a qualified plan.

1. *Defer tax by rolling it over to an eligible retirement plan (qualified plan or IRA).*
2. *Keep the money and pay tax on it.* If the taxpayer elects to pay the tax and was born before 1936, the lump-sum distribution may qualify for 10-year averaging or capital gain tax rates, as discussed above.

3. *Elect to defer the tax on net unrealized appreciation (NUA).* If the lump-sum distribution includes appreciated employer securities, it may be beneficial to pay income tax on the plan's cost basis in the securities and defer the tax on the NUA of the employer securities. When the securities are sold, a special rule applies that defers the tax on the NUA received in a lump-sum distribution and treats the gain as capital gain upon sale.
4. *Transfer to a Roth IRA.* Although tax must be paid on the distribution, all future earnings in the Roth IRA are tax-free.

Dividing Retirement Accounts in Divorce

Qualified Domestic Relations Order (QDRO)

A QDRO is a judgment, decree or court order (including an approved property settlement agreement) issued under a domestic relations law that:

- Relates to the rights of someone other than a participant to receive benefits from a qualified retirement plan (such as most pension and profit-sharing plans) or a tax-sheltered annuity;
- Relates to payment of child support, alimony or marital property rights to a spouse, former spouse, child or other dependent of the participant and
- Specifies the amount or portion of the participant's benefits to be paid to the participant's spouse, former spouse, child or dependent.

A QDRO must specify the following:

- The name and last known mailing address of the participant and each alternate payee covered by the order.
- The amount or percentage of the participant's benefits to be paid by the plan to each alternative payee (or the manner in which such amount or percentage is to be determined).
- The number of payments or period to which the order relates.
- Each qualified retirement plan to which the order applies.

In addition, a QDRO may not require the plan to do any of the following:

- Provide increased benefits.
- Pay benefits to an alternate payee that must already be paid to a different alternate payee under another QDRO.
- Provide a type or form of benefit or any option that is not otherwise provided under the plan. [However, see Section 414(p)(4) for an exception that permits a QDRO to require the payment of "early retirement benefits" to an alternate payee even when the plan participant is not entitled to such benefits.]

Caution: The QDRO requirements are very specific and failure to strictly follow them can result in unplanned and adverse tax consequences.

Tax Effects of QDROs

Benefits paid to a child or dependent. Benefits paid under a QDRO to the plan participant's child or dependent are treated as paid to the participant.

Benefits paid to a spouse or former spouse. Benefits paid under a QDRO to the plan participant's former spouse are included in the former spouse's income.

- The former spouse can use the special rules for lump-sum distributions if the benefits would have been treated as a lump-sum distribution had the participant received them.
- Any distribution received by the former spouse will qualify for rollover treatment in the same manner it would have qualified if the distribution had gone to the plan participant.

The 10% penalty does not apply. The 10% early distribution penalty tax does not apply to a distribution made pursuant to a QDRO. This exception to the penalty tax applies whether the alternate payee is the spouse, former spouse, child or other dependent of the plan participant.

Strategy: If the alternate payee is under age 59½, a distribution from a qualified plan pursuant to a QDRO followed by a rollover to an IRA may not be the best option. Any subsequent distributions from the IRA before age 59½ normally will be subject to the 10% early distribution penalty. If the plan allows, a better solution may be to leave the funds in a segregated account with the plan trustee. Distributions from the segregated account are not subject to the penalty even if made before age 59½. Alternatively, if the balance is rolled over to an IRA, an under-age-59½ participant can receive the balance in the IRA as a series of substantially equal payments and avoid the 10% early withdrawal penalty.

Participant's basis is allocated. If the alternate payee is the former spouse of the plan participant, any basis the participant has in the plan is allocated on a pro rata basis between the present value of the alternate payee's interest and the total present value of all the benefits payable with respect to the plan participant.

Example: Richard's vested balance in his employer's 401(k) plan is $300,000. Pursuant to a QDRO, the plan administrator distributes $150,000 to Elaine, Richard's former spouse and the alternate payee under the QDRO. Elaine may roll over the $150,000 to an IRA within 60 days to avoid current tax. Or, to avoid the 20% federal income tax withholding on the distribution, she could arrange for a direct trustee-to-trustee transfer of the funds from the 401(k) plan to her IRA. (If she chooses this option, a copy of the appropriate IRA documents should be attached to the QDRO when it is presented to the plan administrator to minimize any confusion or opportunity for delay in payment of the benefits.)

Any amount Elaine receives but does not roll over is taxable to her, but it is not subject to the early distribution penalty regardless of her or Richard's age.

Richard is not taxed on the distribution to Elaine nor does the QDRO distribution affect his eligibility for rollovers.

Example: Assume the same facts as in the previous example except Richard had made nondeductible contributions of $30,000 to the plan. His $30,000 basis in the plan is allocated between him and Elaine based on the ratio of their respective interests in the plan. So, $15,000 [$30,000 × ($150,000 ÷ $300,000)] of the $150,000 distribution to Elaine is a nontaxable return of basis and the remaining $135,000 is taxable unless rolled over within 60 days after receipt (or transferred trustee-to-trustee).

Transferring an Interest in an IRA

Transferring an interest in a traditional or Roth IRA to a spouse or former spouse pursuant to a divorce or separate maintenance decree is not a taxable event to either spouse if the decree specifically requires the transfer. The instrument should state that the transfer is intended to be tax-free under the provisions of Section 408(d)(6).

Caution: QDROs do not apply to IRAs. A taxable withdrawal from an IRA by the receiving spouse after the transfer is subject to the 10% early distribution penalty unless another exception to the penalty applies.

Transfer methods. Two commonly used methods of transferring IRA assets to a spouse or former spouse are:

1. Changing the name on the IRA and
2. Making a direct trustee-to-trustee transfer of IRA assets.

Caution: Withdrawing funds from an IRA to satisfy a divorce judgment causes the IRA owner to be taxed on the distribution and, if applicable, imposition of the 10% early withdrawal penalty. The IRA funds should be transferred directly to the other spouse's IRA. In addition, a divorcing couple should be sure that the transfer is made in accordance with a decree of divorce or separate maintenance, and not under a written separation or other agreement between the parties unless it is later incorporated into a divorce decree.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. Margaret, who is 61, has two traditional IRAs at separate institutions. The first IRA consists of $6,000 of deductible contributions. The second IRA consists of $15,000 of nondeductible contributions. During 2010, she took a $4,000 distribution from the second IRA. As of December 31, 2010, the FMV of the first IRA was $18,000, and the FMV of the second IRA was $13,000 (after being reduced by the $4,000 distribution). How much of the distribution is nontaxable?

    a. $1,714.

    b. $2,286.

    c. $3,529.

    d. $4,000.

15. The required minimum distribution (RMD) rules apply to which one of the following choices only after the account owner dies?

    a. Traditional IRA.

    b. 401(k).

    c. Profit sharing plan.

    d. Roth IRA.

16. Arthur died in 2010, before his required beginning date (RBD). His daughter, Abby, is the designated beneficiary of his IRA. How can the distribution be handled?

    a. Abby can defer distributions until December 31 of the calendar year in which Arthur would have reached age 70½.

    b. Abby can defer the distribution until the end of the fifth year after the year Arthur died.

    c. Abby can elect to treat Arthur's IRA as her own.

17. Which of the following distributions is subject to a 10% penalty?

    a. Pat is the sole beneficiary of his father's IRA. After Pat's father passed away, Pat withdrew the entire IRA.

    b. Beverly made an early withdrawal from a SIMPLE IRA during the two-year initial participation period.

    c. Ted is recently disabled and is having trouble making ends meet.

    d. Polly received an early distribution that constitutes a return of cost.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. Margaret, who is 61, has two traditional IRAs at separate institutions. The first IRA consists of $6,000 of deductible contributions. The second IRA consists of $15,000 of nondeductible contributions. During 2010, she took a $4,000 distribution from the second IRA. As of December 31, 2010, the FMV of the first IRA was $18,000, and the FMV of the second IRA was $13,000 (after being reduced by the $4,000 distribution). How much of the distribution is nontaxable? **(Page 87)**

    a. $1,714. [This answer is correct. Of the $4,000 distribution, $1,714 of the distribution is a tax-free return of basis. (($15,000/($18,000 + $13,000 + $4,000)) × $4,000 = $1,714) When calculating the amount of nontaxable distributions, the total FMV of all the individual's traditional IRAs must be included in the fraction's denominator.]

    b. $2,286. [This answer is incorrect. This is the taxable portion of the distribution. ($4,000 - $1,714)]

    c. $3,529. [This answer is incorrect. The FMV of the first IRA must be included in the fraction's denominator when calculating the nontaxable portion of the distribution. The total FMV of all the individual's traditional IRAs is included in the fraction's denominator.]

    d. $4,000. [This answer is incorrect. The entire distribution is not a tax-free return of basis. The determination is based on both IRAs. In addition, the calculation includes the FMV of the IRAs at year-end which takes into account the appreciation of IRA assets.]

15. The required minimum distribution (RMD) rules apply to which one of the following choices only after the account owner dies? **(Page 90)**

    a. Traditional IRA. [This answer is incorrect. Annual RMDs from traditional IRAs must begin by the year the taxpayer reaches age 70½.]

    b. 401(k). [This answer is incorrect. Since a 401(k) is a qualified plan, it is not subject to the RMD rules until the year the participant retires, even if over age 70½. However, distributions cannot be delayed until after the account owner dies.]

    c. Profit sharing plan. [This answer is incorrect. RMDs are required once the owner turns 70½, unless he is not retired. Distributions are not waived until after the account owner dies.]

    d. Roth IRA. [This answer is correct. The RMD rules do not apply to Roth IRAs until the account owner dies. This is a significant advantage of the Roth IRA for individuals who plan to accumulate wealth in their retirement plans to pass on to their heirs.]

16. Arthur died in 2010, before his required beginning date (RBD). His daughter, Abby, is the designated beneficiary of his IRA. How can the distribution be handled? **(Page 95)**

    a. Abby can defer distributions until December 31 of the calendar year in which Arthur would have reached age 70½. [This answer is incorrect. If Arthur died before his RBD and the surviving spouse was the sole designated beneficiary, the surviving spouse could defer distributions until December 31 of the calendar year in which Arthur would have reached age 70½. Since Abby is his daughter, this delay is not allowed.]

    b. Abby can defer the distribution until the end of the fifth year after the year Arthur died. [This answer is correct. Since Arthur died before the RBD and Abby is not the participant's spouse, either the five-year rule or the life expectancy rule applies. Under the five-year rule, the entire account must be distributed by the end of the fifth year after the year Arthur dies. No distribution is required for any year before the fifth year.]

    c. Abby can elect to treat Arthur's IRA as her own. [This answer is incorrect. A surviving spouse can elect to treat Arthur's IRA as her own. However, since Abby is his daughter, this election is not allowed.]

17. Which of the following distributions is subject to a 10% penalty? **(Page 99)**

    a. Pat is the sole beneficiary of his father's IRA. After Pat's father passed away, Pat withdrew the entire IRA. [This answer is incorrect. The 10% penalty does not apply to a distribution received by a taxpayer who is the beneficiary of a deceased owner/participant.]

    b. Beverly made an early withdrawal from a SIMPLE IRA during the two-year initial participation period. [This answer is incorrect. Early withdrawals from a SIMPLE IRA occurring during the two-year period following the date of initial participation in the plan are subject to a 25% tax, rather than 10%.]

    c. Ted is recently disabled and is having trouble making ends meet. Ted takes a hardship distribution from his 401(k). [This answer is correct. Hardship distributions are subject to the 10% penalty. However, if the distributions are specifically for deductible medical or qualified education expenses, they may qualify for an exception to the 10% penalty.]

    d. Polly received an early distribution that constitutes a return of cost. [This answer is incorrect. The 10% penalty does not apply to any part of a distribution that is tax-free, such as amounts that represent a return of cost.]

EXAMINATION FOR CPE CREDIT

Lesson 6

Determine the best answer for each question below. Then log on to our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

14. Parker, age 63, has a traditional IRA. Generally, is he required to take distributions, and would the distributions be subject to the early distribution penalty?

    a. Parker is not required to take distributions, nor is he subject to the 10% penalty.

    b. Parker is not required to take distributions, but he is subject to the penalty on any distribution.

    c. Parker is required to take distributions, but he is not subject to the 10% penalty.

    d. Parker is required to take distributions, and is subject to the penalty on any distribution.

15. Ben turned 70 on January 1, 2010. He has a traditional IRA. When will he be required beginning date (RBD) to take minimum distributions from his IRA?

    a. January 1, 2010.

    b. July 1, 2010.

    c. December 31, 2010.

    d. April 1, 2011.

16. Beverly died on September 30, 2008. Her beneficiaries will use the five-year rule to fulfill the RMD for her IRA. Determine if the waiver of RMDs for 2009 applies to Beverly's IRA. What date is the IRA required to be distributed?

    a. September 30, 2013.

    b. December 31, 2013.

    c. September 30, 2014.

    d. December 31, 2014.

17. Which of the following distributions is exempt from the 10% penalty tax for early distributions?

    a. Ted, 55, receives distributions from his 401(k) while he is still employed.

    b. Barb, 56, is taking substantially equal payments (SEPPs) from her IRA.

    c. Bart, 57, takes early retirement and receives a distribution from his IRA.

    d. Sam, 56, is self-employed. He takes a distribution from his SEP.

Lesson 7: Rollovers

Learning Objectives

Completion of this lesson will enable you to:

- Determine the requirements for a tax-free rollover of all types of retirement plans and which types of plans can be rolled over into other types of retirement plans.

Overview

Generally, a rollover is a tax-free distribution of cash or other assets from one retirement plan that is contributed to another retirement plan. The contribution to the second retirement plan is called a *rollover contribution*. Rollover contributions are not counted toward the annual limit on IRA contributions or toward the limit on annual additions to qualified plans.

Certain requirements must be met to qualify for tax-free rollover treatment.

Funds can also be rolled from a retirement plan (including an IRA or qualified plan) to a Roth IRA. While many of the rules that apply to rollovers discussed in this lesson apply to rollovers to a Roth IRA, a major difference is that a rollover to a Roth IRA triggers taxable income as if the funds had been distributed to the account owner.

Partial Rollovers

Some or all of an eligible rollover distribution may be rolled over to another qualified plan or IRA. Any portion of the distribution not rolled over within 60 days is taxed on the date it was received, not the 60th day after the withdrawal. If a lump-sum distribution is received from a qualified plan, it may qualify for special tax treatment. However, if any part of the distribution is rolled over, the part the taxpayer keeps does not qualify for special tax treatment.

How to Roll Over a Distribution

Distributions can be rolled over in two ways:

1. Transferred through a direct rollover, in which the payout is transferred directly from one trustee (or custodian or plan administer) to another qualified plan that accepts rollover distributions or to a traditional or Roth IRA.
2. The participant or owner can receive the distribution personally and then make the transfer on his own. If the rollover distribution is paid to the taxpayer from a qualified plan, it generally is subject to mandatory tax withholding.

Note: Qualified plans are not required, or in the case of IRAs, may not be able to, accept rollovers. They may accept only certain types of rollovers and not others. A qualified plan must maintain special accounts if accepts certain types of rollovers, thus increasing its administrative costs. The *Retirement Plan Rollover Chart* shows the types of rollovers allowed by law, but the final answer is with the specific plan and whether the plan accepts a certain type of rollover.

Tax Treatment of Rollovers

Although a rollover itself is tax-free, a rollover from a qualified plan or non-Roth IRA simply postpones the income tax. The funds will ultimately be taxable when withdrawn (except for any portion representing basis—that is, attributable to nondeductible contributions).

Strategy: The primary benefit of a rollover is to continue to build retirement savings in a tax-efficient manner, since the earnings aren't taxed until withdrawn. Thus, a rollover is especially beneficial if the taxpayer's income tax rate is likely to be lower when the assets are withdrawn.

Exception: A rollover to a Roth IRA triggers taxable income as if the funds rolled over had been distributed to the account owner. However, qualifying distributions from the Roth IRA are income tax-free.

A rollover contribution cannot be deducted. Instead, the rollover distribution must be reported on the recipient's tax return.

Retirement Plan Rollover Chart

Roll From \ Roll To	IRA (Traditional)	SEP-IRA	SIMPLE IRA	Roth IRA	457(b)	403(b)	Qualified Plan	Designated Roth Account
IRA (Traditional)	Yes	Yes	No	Yes, must include in income.	Yes, must have separate accounts.	Yes	Yes.	No
SEP-IRA	Yes	Yes	No	Yes, must include in income.	Yes, must have separate accounts.	Yes	Yes.	No
SIMPLE IRA	Yes, after two years.	Yes, after two years.	Yes	Yes, after two years. Must include in income.	Yes, after two years. Must have separate accounts.	Yes, after two years.	Yes, after two years.	No
Roth IRA	No	No	No	Yes	No	No	No	No
457(b)	Yes	Yes	No	Yes, must include in income.	Yes	Yes	Yes	No
403(b)	Yes	Yes	No	Yes, must include in income.	Yes, must have separate accounts.	Yes	Yes	No
Qualified Plan	Yes	Yes	No	Yes, must include in income.	Yes, must have separate accounts.	Yes	Yes	No
Designated Roth Account	No	No	No	Yes	No	No	No	Yes, if a trustee-to-trustee transfer.

Note: Although permitted under the tax laws, some rollovers are subject to the particular terms of the plan.

Rollovers from IRAs

Traditional IRAs

Distributions from traditional IRAs [other than those required to be distributed under the required minimum distribution (RMD) rules] generally are eligible for tax-free rollovers. IRA distributions generally can be rolled over to any eligible retirement plan. *Exception:* The portion of an IRA distribution that would be tax-free if distributed can only be rolled over to another IRA.

Eligible retirement plans:

- IRAs.
- Qualified plans.
- 403(a) plans.
- 403(b) plans.
- 457 plans (deferred compensation plans of state and local governments).

Note: Traditional IRAs may also be converted to a Roth IRA (often referred to as a *Roth conversion*). The conversion is treated as a rollover, but usually is not tax-free.

IRA distributions with tax basis. IRA distributions attributable to nondeductible contributions (that is, the part of the distribution that is normally nontaxable) can only be rolled over into another IRA. However, amounts that would otherwise be taxable can be rolled over to any eligible retirement plan.

Normally, when an IRA has basis (because nondeductible contributions were made), any distribution includes both nontaxable and taxable amounts. Without a special rule, all distributions would include a portion of the individual's basis that could not be rolled over to a qualified plan. (It could only be rolled into an IRA.) However, if the amount left in the IRA or not rolled over is at least equal to the tax basis, a special rule treats a distribution rolled over into a qualified plan as including only otherwise taxable amounts. This maximizes the rollover amount to a qualified plan.

Note: When calculating the taxable distribution that can be rolled over, the taxable amount of all the owner's traditional IRAs is considered. This means that an individual can roll over the entire amount of an IRA to a qualified rollover plan, even if it contains what would otherwise be a nontaxable portion, as long as the amount in all of the individual's remaining IRAs is at least equal to his basis in them.

Example: Janet has the following two IRAs:	
	FMV
IRA 1 (funded only with deductible contributions, so all withdrawals are taxable)	$100,000
IRA 2 (funded with $80,000 deductible contributions and $50,000 nondeductible contributions)	$150,000
She withdraws $80,000 from IRA 2. She can roll over the entire $80,000 into a qualified plan because the $170,000 remaining in the IRAs ($100,000 + $150,000 – $80,000) is more than her $50,000 basis.	

After rolling over the $80,000, Janet still has:	
	FMV
IRA 1	$100,000
IRA 2 ($50,000 basis and a $20,000 taxable portion.)	$70,000

Roth IRAs

Distributions from a Roth IRA may be rolled over tax-free (and penalty-free) into another Roth IRA under the same rules that apply to traditional IRAs. However, a rollover from a Roth IRA to an employer retirement plan is not allowed. A rollover from a designated Roth account can only be made to another designated Roth account or to a Roth IRA.

Rollovers from SIMPLE IRAs

Rollovers and trustee-to-trustee transfers from SIMPLE IRAs are generally tax-free, but special rules apply. **Note:** The rollover must occur within 60 days after the employee receives the distributions.

Two-Year Rule

To qualify as a tax-free rollover (or a tax-free trustee-to-trustee transfer), a rollover distribution (or a transfer) made from a SIMPLE IRA during the two-year period beginning on the date on which an employee first participated in an employer's SIMPLE plan must be contributed (or transferred) to another SIMPLE IRA. The two-year period begins on the first day on which contributions made by the employer are deposited in the employee's SIMPLE IRA.

Caution: During the two-year period described above, distributions from the SIMPLE IRA can only be rolled over tax-free to another SIMPLE IRA. A transfer from a SIMPLE IRA to a traditional IRA during this period is not a tax-free rollover. Instead, the transfer is not only taxable (and possibly subject to the 25% early distribution tax, but also an excess IRA contribution to the extent it, plus other contributions made to the individual's traditional and Roth IRAs, exceeds $5,000 ($6,000 if age 50 or older) for 2010).

Post-Two-Year Period

After the two-year period, amounts in a SIMPLE IRA can be rolled over or transferred tax-free to SIMPLE IRAs and traditional IRAs, qualified plans, tax-sheltered annuity plans [Section 403(b) plans] or deferred compensation plans of a state or local government (Section 457 plans). They can also be converted to Roth IRAs.

Rollovers from Qualified Plans

Taxpayers can roll over eligible rollover distributions from qualified plans, including the portion representing after-tax contributions, into another eligible retirement plan. The general rules for rollovers apply. However, the once-a-year limit on IRA-to-IRA rollovers does not apply to eligible rollover distributions from a qualified plan. Taxpayers can roll over more than one distribution from the same employer within a year.

Note: These rules for rolling over qualified plan distributions also apply to distributions from 403(a) plans, 403(b) annuities and 457 plans.

Caution: Although the once-a-year limit on IRA-to-IRA rollovers does not apply to distributions from a qualified plan, plans can limit recipients to one single direct rollover for each eligible rollover distribution.

Eligible Rollover Distributions

Any distribution from a qualified plan is eligible for rollover, *except:*

- Required minimum distributions beginning at age 70½ or retirement.
- Distributions paid at least annually over life expectancy.
- Distributions paid as installments for at least 10 years.
- Return of excess contributions or deferrals under 401(k) plans.
- Imputed distributions of life insurance protection (P.S. 58 costs).
- Plan loans that are deemed to be distributions either upon origination or default.
- Distributions of employee stock ownership plan (ESOP) stock dividends made pursuant to Section 404(k).
- Hardship distributions from 401(k) and 403(b) plans.

Note: A distribution to the IRA owner's or qualified plan participant's beneficiary generally is not treated as an eligible rollover distribution.

Rollovers of After-Tax Contributions

The nontaxable part of a qualified plan distribution (such as after-tax contributions) can be rolled over to:

- Another qualified plan or a 403(b) plan (if a direct rollover and the plan separately accounts for the taxable and non-taxable parts of the rollover).
- A traditional or Roth IRA.

Note: Any after-tax contributions rolled over into a traditional IRA increase the individual's basis in the IRAs, which the individual must track on Form 8606.

Direct Rollover Option

A qualified plan must give the participant the option to have any part of an eligible rollover distribution paid directly to a traditional or Roth IRA or to another qualified plan that accepts rollover distributions [IRC §401(a)(31); Reg. §1.401(a)(31)-1, Q-1]. However, the plan is not required to provide this option if the taxpayer's eligible rollover distributions are expected to be less than $200 for the year. No tax withholding is imposed on a direct rollover.

A direct rollover may be made for the following individuals:

- Employee.
- Employee's surviving spouse.

- Spouse or former spouse who is an alternate payee under a qualified domestic relations order (QDRO)
- Nonspouse designated beneficiary (in which case the direct rollover can only be made to an inherited IRA).

If the distribution is paid to the surviving spouse, the distribution is treated the same as if the spouse were the employee.

Automatic rollover for mandatory distributions. An automatic rollover requirement applies for mandatory distributions that are eligible rollover distributions of more than $1,000 [IRC §401(a)(31)(B)]. Mandatory distributions (commonly referred to as *cash-outs*) are distributions made to the taxpayer:

- Without his or her consent or
- Before attaining age 62 or normal retirement age, whichever is later.

The taxpayer can choose to have the distribution paid directly to himself or rolled over directly to his traditional or Roth IRA or to another qualified plan. If this choice is not made, the plan administrator will automatically roll over the distribution into an IRA of a designated trustee or issuer.

Observation: Unlike trustee-to-trustee transfers between traditional IRAs, which are not counted as rollovers or reported on Form 1099-R, direct rollovers from a qualified plan to an IRA are treated as distributions and subsequent rollover contributions by the participant.

Rollovers from Qualified Plans to Conduit IRAs

A conduit IRA is created to receive funds from a qualified plan, with the intention of rolling the funds from one qualified plan into another. Because qualified plans are not required to accept direct rollovers, a conduit IRA can hold the distributed funds (and allow them to accumulate income tax deferred) until the participant is covered by a qualified plan willing to accept the rollover contribution.

To qualify as a conduit IRA, the entire amount in the account must be attributable solely to the rollover contribution from the first employer's plan, plus earnings on that contribution. Contributions or funds from other sources cannot be commingled with the account.

The rollover from the conduit IRA to the qualified plan must be made within 60 days of the participant's receipt from the conduit IRA.

The conduit IRA can be rolled over to a qualified plan, even if regular contributions are made to it or funds are added from sources other than the qualified plan. However, if regular contributions are made to the conduit IRA or funds are added from other sources, the qualified plan into which the funds are moved will not be eligible for any optional tax treatment, such as 10-year averaging or capital gain elections, for which it might otherwise have qualified.

Example: Several years ago, Joan received a $100,000 eligible rollover distribution from her employer's noncontributory qualified plan. Joan rolled over the entire distribution into an IRA. She has not made any other contributions to, or mixed funds from any other source with, this IRA.

Joan recently went to work for an employer who has a qualified plan that accepts rollover contributions from conduit IRAs. The amount in her IRA account is $110,000.

Because her IRA account meets the definition of a conduit IRA, Joan can withdraw the $110,000 and contribute it to her new employer's plan within 60 days of receipt. Doing so will accomplish a tax-deferred rollover. Furthermore, if Joan later receives a qualifying lump-sum distribution from her new employer's plan, the entire taxable portion of the distribution will qualify for the special tax benefits available for lump-sum distributions.

Rollovers from Designated Roth Accounts

Amounts from a designated Roth account can only be rolled over into another designated Roth account or a Roth IRA. A designated Roth account is a separate account created under a qualified Roth contribution program to which participants may elect to have part or all of their elective deferrals to a 401(k) or 403(b) plan designated as Roth contributions. Distributions from these accounts are treated separately from other distributions from the plan. If the participant's balance in the designated Roth account is less than $200, the plan is not required to offer a direct rollover election or to apply the mandatory provisions to the balance.

A qualified distribution from a designated Roth account is not includible in income. If a direct rollover is made from a designated Roth account under another plan, the five-tax-year period of participation begins on the earlier of the first day of the tax year in which the taxpayer first designated Roth contributions:

- Made to the account making the distribution, or
- Made to the account receiving the distribution.

If only part of an eligible rollover distribution that is not a qualified distribution is rolled over and not paid as a direct rollover contribution, the part rolled over is considered to be first from the income portion of the distribution.

Tax Withholding Requirements

Eligible rollover distributions from a qualified plan, 403(a) plan, 403(b) plan or 457 plan (not an IRA) are subject to a 20% federal income tax withholding (up to the taxable amount of cash and property received other than employer stock). However, withholding can be avoided if the direct rollover option is chosen. Additionally, beginning in 2010, eligible rollover distributions from a qualified plan (not an IRA) paid directly to nonspouse beneficiaries are subject to the mandatory 20% federal income tax withholding.

Example: Marvin, age 65, is retiring from Acme Co. His account in the Acme Profit-Sharing Plan is worth $100,000. Marvin has never contributed to the profit sharing plan, so any distributions are 100% taxable. Marvin wants to withdraw his entire balance in the plan and decide later whether to roll over any of that amount. The plan trustee must withhold $20,000 ($100,000 × 20%) of the distribution, so Marvin receives only $80,000, even though he has a $100,000 taxable distribution.

Variation: Assume that Marvin's $100,000 balance includes $5,000 of after-tax plan contributions. Here, only $95,000 ($100,000 – $5,000) would be taxable if Marvin withdrew his entire $100,000 balance. The plan trustee would only have to withhold $19,000 ($95,000 × 20%) if Marvin requested that his entire account balance be distributed.

Exceptions from withholding requirements. Tax withholding is not required if the eligible rollover distribution:

- And all previous eligible rollover distributions received during the year from the same plan (or, at the payer's option, from all of the employer's plans) total less than $200, or
- Consists only of employer securities, plus cash of $200 or less in lieu of fractional shares.

Additionally, an eligible rollover distribution is not subject to withholding to the extent it consists of net unrealized appreciation from employer securities that can be excluded from gross income.

Direct Rollover Option

If the direct rollover option is chosen (that is, part or all of an eligible rollover distribution is paid directly to another eligible retirement plan that accepts rollover contributions, no tax is withheld from any part of the distribution that is directly paid to the trustee, custodian or plan administrator.

Strategy: If the taxpayer plans to roll the distribution over, tax withholding can be avoided by choosing the direct rollover option.

Payments Received By Taxpayer

For distributions made from a qualified plan, 403(a) plan, 403(b) plan or 457 plan, the employer must withhold 20% of the eligible rollover distribution (if over $200), regardless of whether the taxpayer plans to roll over the distribution.

The full amount will be treated as distributed to the taxpayer even though he actually received only 80%. The amount not rolled over within 60 days must generally be included in income (including the part withheld).

Strategy: Although IRA distributions are not subject to the 20% withholding tax, a taxpayer may elect to have taxes withheld.

Caution: If the taxpayer is under age 59½ when a distribution is received, he may be subject to a 10% penalty tax (in addition to the regular income tax) on the taxable part (including any tax withheld) that was not rolled over.

Example: Omar, age 45, has $50,000 in a qualified pension plan. His employer terminates the plan and distributes all of the plan assets. The employer withholds $10,000 for federal taxes and distributes $40,000 to Omar. Omar rolls the $40,000 into his IRA. The $10,000 not rolled over is subject to income tax plus the 10% early withdrawal penalty.

To avoid the tax, Omar must come up with an additional $10,000 to roll into his IRA. All of this would be avoided if Omar had directed his employer to transfer the funds directly into his IRA.

Time Limit for Making a Rollover

General 60-Day Rule

To avoid current income taxation on the receipt of a distribution from an IRA or qualified plan, the distribution must be rolled over by the 60th day after the day it is received.

Example: Joyce intends to roll over the funds in the IRA she currently owns into a new IRA she has established. The withdrawal will occur on February 28, 2010.

The 60-day period starts to run the day after the distribution is received (March 1, 2010). Thus, the contribution to the new IRA must occur on or before April 29, 2010.

Exceptions

In certain situations, the IRS will either automatically waive this 60-day requirement or will do so upon special request due to extenuating circumstances beyond the taxpayer's control.

Rollovers Completed after the 60-Day Period

Without a waiver or extension of the 60-day rollover period, amounts not rolled over within the 60-day period do not qualify for tax-free rollover treatment. Instead, they must be treated as a taxable distribution from the IRA or qualified plan. These amounts are taxable in the year distributed, even if the 60-day period expires in the next year. They may also be subject to a 10% additional tax on early distributions.

Example: Jake received a distribution in late December 2010 from a traditional IRA that he doesn't roll over into another traditional IRA within the 60-day limit. This distribution is taxable in 2010 even though the 60-day limit was not up until 2011.

Waivers to Time Limit

Automatic Waivers

The 60-day rollover requirement is waived automatically (that is, no request for letter ruling is necessary) only if all of the following apply:

- The financial institution receives the taxpayer's funds before the end of the 60-day rollover period.
- The taxpayer followed all the procedures set by the financial institution for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan).
- The funds are not deposited into an eligible retirement plan within the 60-day rollover period solely because of an error on the part of the financial institution.
- The funds are deposited into an eligible retirement plan within one year from the beginning of the 60-day rollover period.
- It would have been a valid rollover if the financial institution had deposited the funds as instructed.

Waiting between IRA Rollovers

IRAs (but not qualified plans) are limited to a single tax-free rollover in any 365-day period. The one-year waiting period applies from the date the first IRA withdrawal is made, rather than the date it is rolled over to another IRA, and applies separately to each IRA owned by the taxpayer.

Example: Connor has two traditional IRAs, IRA-1 and IRA-2. He makes a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3). He cannot, within one year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA. However, the rollover from IRA-1 into IRA-3 does not prevent him from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because he has not, within the last year, made a tax-free rollover of any distribution from IRA-2 or made a tax-free rollover into IRA-2.

Exception. If a distribution meets all of the following requirements, the one-year waiting rule does not apply:

1. It is made from a failed financial institution by the Federal Deposit Insurance Corporation (FDIC) as receiver for the institution.
2. It was not initiated by either the custodial institution or the depositor.
3. It was made because:
   a) The custodial institution is insolvent and
   b) The receiver is unable to find a buyer for the institution.

Note: The once-a-year limit on IRA-to-IRA rollovers does not apply to eligible rollover distributions from a qualified plan. A taxpayer can roll over more than one distribution from the same employer plan within a year.

Consequences of Failed Rollovers

The taxpayer must strictly comply with the technical requirements when rolling over distributions from IRAs and qualified plans. Mistakes such as missing the 60-day rollover period, exceeding the one-per-year IRA rollover rule, rolling over more than the eligible amount or transferring IRA funds between spouses can result in adverse tax results that may not be correctable.

Rollover Mistakes Resulting in Tax

A failed rollover contribution (invalid rollover) can have several unfavorable consequences. A distribution transferred to another IRA or qualified plan in a transaction that does not meet the requirements of a rollover is taxable in the year distributed. It may also be subject to the 10% early distribution tax.

Excess IRA contributions. Invalid IRA rollovers may result in a penalty tax, in addition to the distribution being subject to income tax (and potentially the early distribution tax). If the amount of the invalid rollover to another IRA exceeds the annual IRA contribution limit [$5,000 for 2010 ($6,000 if age 50 or older by December 31, 2010)], the excess contribution is subject to a 6% penalty tax.

This 6% penalty tax applies not only to the year of over-funding due to the invalid rollover, but for every year thereafter until the excess is eliminated. The tax is paid by the IRA owner.

Observation: Although the tax is imposed on the excess, it is limited to the IRA value at the end of the tax year. So if the value of the assets in the IRA decreases, the tax is avoided or limited since the excess contributions have vanished.

Note: The excess contributions tax does not apply to qualified plans.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. A rollover is a tax-free distribution of cash or other assets from one retirement plan that is contributed to another retirement plan. Which of the following is true for rollovers?

    a. If funds are rolled over into a Roth IRA, it triggers taxable income for the account owner.

    b. If property other than cash is included in the rollover, the account owner may keep the property and substitute cash and maintain a tax-free transaction.

    c. Contributions through a rollover count towards the yearly limit on IRA contributions.

    d. Distributions not rolled over are taxed on the 60th day after withdrawal from a qualified plan.

19. Which of the following is correct for a rollover from a SIMPLE IRA?

    a. The once-a-year limit on rollovers does not apply to eligible rollovers from a SIMPLE IRA.

    b. A SIMPLE IRA can only ever be transferred to another SIMPLE IRA plan.

    c. The rollover must be contributed to another SIMPLE IRA plan within a two year period to qualify as tax-free.

20. In which of the following examples would a letter ruling be necessary for the 60-day rollover requirement to be waived?

    a. Stacy decides to rollover her traditional IRA into a Roth IRA and informs her financial group of her decision. The financial group distributed the funds but did not deposit the funds in the new IRA because the plan administrator quit his position and the paperwork for the transfer wasn't found until 75 days after the distribution.

    b. Hugh accepted a distribution from his employer's pension plan on January 1. On February 1, Hugh gave his financial institution his distribution and all the accompanying paperwork to deposit it in a traditional IRA for Hugh. The institution did not set up the new IRA account until March 15th.

    c. Leah received a distribution from her husband's employer retirement account upon his passing on February 15th. Leah did not rollover the distribution to another IRA account until December 15th of the same year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. A rollover is a tax-free distribution of cash or other assets from one retirement plan that is contributed to another retirement plan. Which of the following is true for rollovers? **(Page 109)**

    a. If funds are rolled over into a Roth IRA, it triggers taxable income for the account owner. [This answer is correct. Funds can also be rolled from a retirement plan to a Roth IRA, but a major difference for a rollover to a Roth IRA is that is triggers taxable income as if the funds had been distributed to the account owner as detailed by the IRS.]

    b. If property other than cash is included in the rollover, the account owner may keep the property and substitute cash and maintain a tax-free transaction. [This answer is incorrect. When a distribution from an employer's retirement plan or IRA contains any property other than cash, either the property itself must be rolled over, or the property must be sold and the proceeds rolled over for the transaction to the tax-free. The taxpayer may not retain the property and substitute other funds as indicated in Rev. Rul 87-77.]

    c. Contributions through a rollover count towards the yearly limit on IRA contributions. [This answer is incorrect. Rollover contributions are not counted toward the annual limit on IRA contributions as stated in IRC Section 408(a)(1) or toward the limit on annual additions to qualified plans according to IRC Section 415(c)(2).]

    d. Distributions not rolled over are taxed on the 60th day after withdrawal from a qualified plan. [This answer is incorrect. Any portion of a distribution not rolled over within 60 days is taxed on the date it was received, not on the 60th day after the withdrawal.]

19. Which of the following is correct for a rollover from a SIMPLE IRA? **(Page 112)**

    a. The once-a-year limit on rollovers does not apply to eligible rollovers from a SIMPLE IRA. [This answer is incorrect. The once-a-year limit does apply to a SIMPLE IRA. It is still a $5,000 annual limit ($6,000 if age 50 or older) for 2010. The once-a-year limit on IRA-to-IRA rollovers does not apply to eligible rollover distributions from a qualified plan.]

    b. A SIMPLE IRA can only ever be transferred to another SIMPLE IRA plan. [This answer is incorrect. After the two-year stipulation, amounts in a SIMPLE IRA can be rolled over or transferred tax-free to SIMPLE IRAs and traditional IRAs, qualified plans, tax-sheltered annuity plans or deferred compensation plans of a state or local government. They can also be converted to Roth IRAs.]

    c. The rollover must be contributed to another SIMPLE IRA plan within a two year period to qualify as tax-free. [This answer is correct. To qualify as a tax-free rollover, a rollover distribution must be made from a SIMPLE IRA during the two-year period beginning on the date on which an employee first participated in an employer's SIMPLE IRA as stated in IRC Section 408(d)(3)(G). The two-year period begins on the first day on which contributions made by the employer are deposited in the employee's SIMPLE IRA.]

20. In which of the following examples would a letter ruling be necessary for the 60-day rollover requirement to be waived? **(Page 117)**

    a. Stacy decides to rollover her traditional IRA into a Roth IRA and informs her financial group of her decision. The financial group distributed the funds but did not deposit the funds in the new IRA because the plan administrator quit his position and the paperwork for the transfer wasn't found until 75 days after the distribution. [This answer is incorrect. The 60-day rollover requirement is waived automatically if the funds are not deposited into an eligible retirement plan within the 60-day rollover period solely because of an error on the part of the financial institution.]

    b. Hugh accepted a distribution from his employer's pension plan on January 1. On February 1, Hugh gave his financial institution his distribution and all the accompanying paperwork to deposit it in a traditional IRA for Hugh. The institution did not set up the new IRA account until March 15th. [This answer is incorrect. The 60-day rollover requirement is waived automatically if the financial institution receives the taxpayer's funds before the end of the 60-day rollover period and does not follow the procedures to deposit the funds into an eligible retirement plan within the 60-day period.]

    c. **Leah received a distribution from her husband's employer retirement account upon his passing on February 15th. Leah did not rollover the distribution to another IRA account until December 15th of the same year. [This answer is correct. Leah would not qualify for an automatic waiver of the 60-day requirement due to the amount of time that has passed since the date of distribution. She can apply to the IRS for a waiver of the 60-day rollover requirement by submitting a request for a letter ruling under the appropriate IRS revenue procedure stating that she was unable to complete the rollover due to a death.]**

EXAMINATION FOR CPE CREDIT

Lesson 7

Determine the best answer for each question below. Then log on to our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

18. Which of the following rollovers are allowable without a waiting period?

    a. Rollover from SIMPLE IRA to a traditional IRA.

    b. Rollover from a Designated Roth Account to a SEP-IRA.

    c. Rollover from a Roth IRA to a qualified plan.

    d. Rollover from a qualified plan to a traditional IRA

19. Gavin has two IRAs in 2010 with the following FMVs:

	FMV
IRA 1 (funded with $100,000 deductible contributions and $100,000 nondeductible contributions)	$200,000
IRA 2 (funded with all deductible contributions)	$100,000

    Gavin withdraws $50,000 from IRA 1 by the end of 2010. How much of the withdrawal could Gavin roll over into a qualified plan?

    a. $0.

    b. $50,000.

    c. $100,000.

    d. $250,000.

20. In January, 2010, Ed had $35,000 in his qualified pension plan. His employer, Benson Enterprises, decided in April, 2010 to terminate the plan and distribute all of the plan assets. At the time of termination, the company withheld $5,000 to pay federal taxes and distributed $30,000 to Ed. If Ed wants his rollover to be tax-free, how much must he rollover to his IRA?

    a. $0.

    b. $5,000.

    c. $30,000.

    d. $35,000.

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Glossary

Conduit IRA – An IRA whose entire account balance consists of a rollover contribution from a qualified retirement plan and any earnings on that contribution. A conduit IRA can be rolled over to another qualified plan, preserving tax benefits (for example, five-year averaging) available only to qualified plan distributions.

Designated beneficiary – The beneficiary of qualified retirement plan or IRA benefits whose life expectancy is used to determine minimum required distributions. Must be an individual or a qualified trust.

Designated Roth account – A separate account created under a qualified Roth contribution program to which participants may elect to have some or all of their elective deferrals to a 401(k) or 403(b) plan designated as Roth contributions. Elective deferrals that are designated Roth contributions are included in income. However, qualified distributions from the designated Roth account are not taxable.

Direct rollover – The direct payment of a distribution from a qualified plan, Section 403(b) or Section 457 plan to an eligible retirement plan. The payment is made by the trustee or custodian of the paying plan directly to the receiving plan.

Eligible retirement plan – A retirement plan that can receive the funds in a rollover transaction. IRAs, SEPs, SIMPLE plans, qualified plans, Section 403(a) and 403(b) plans and Section 457 plans are eligible retirement plans.

Eligible rollover distribution – A distribution from a qualified plan, Section 403(a) plan, Section 403(b) annuity or Section 457 plan that can be rolled over to an eligible retirement plan. It is subject to mandatory 20% withholding unless transferred through a direct rollover.

Individual Retirement Account (IRA) – Qualified taxpayers may annually set aside limited amounts of earned income for a retirement fund. The amount set aside may be deductible, partially deductible, or nondeductible depending on whether the taxpayer is an active participant in an employer-maintained retirement plan, and depending on AGI and the amount of the contribution. Money earned by an IRA is tax-deferred until withdrawn. Specific requirements cover the withdrawal of funds from IRAs, and there are penalties for noncompliance. For all years before 2002, the annual contribution allowed was limited to $2,000 per year. The maximum annual contribution allowed has been increased to $3,000 for 2002.

Lump-sum distribution – A distribution (or several distributions) of a plan participant's entire balance within a single tax year from all of the employer's qualified plans of one kind (pension, profit-sharing or stock bonus) paid because the participant:

1. Has died,
2. Has reached age 59½,
3. Separates from service or
4. Becomes totally and permanently disabled (if self-employed).

Net unrealized appreciation (NUA) – The excess of the aggregate FMV of securities over their aggregate basis.

Required beginning date – April 1 of the calendar year following the year in which an individual reaches age 70½ (or, for participants of qualified plans, April 1 of the year following the year of the participant's retirement from the employer sponsoring the plan, if later). Under the minimum distribution rules, qualified retirement plan and traditional IRA (not Roth IRAs) benefits must be distributed or begin being distributed by this date.

Rollover – A distribution from a retirement plan followed by a contribution to an eligible retirement plan within 60 days of receipt. If all criteria are met, the distribution (unless from a Roth IRA) is tax-free.

Simplified employee pension (SEP) plan – In general, simplified employee pension (SEP) plans were established by employers and funded by employer contributions to employee IRAs. SEP plans were created to give small businesses a method of providing retirement benefits to employees without having to meet the complex requirements associated with other qualified plans.

Savings incentive match plan (SIMPLE IRA) – A savings incentive match plan for employees (SIMPLE) became available in taxable year 1997. An employer with 100 or fewer employees is able to adopt this new type of retirement savings plan for employees. The new plan is "simple" to maintain, has higher limits, and is available to a larger number of "small employers." In general, a SIMPLE plan can be either an IRA (individual retirement account) or a 401(k). For an IRA SIMPLE plan, individual IRA accounts are set up for employees. For a 401(k) SIMPLE plan, individual 401(k) accounts are set up for the employees.

Trustee-to-trustee transfer – A transfer of funds in one traditional IRA to another traditional IRA made directly from one trustee to the other trustee, either at the owner's request or at the trustees' request. This is not a rollover, but it is tax-free.

Qualified plan – A plan established under Section 401 of the Internal Revenue Code by an employer to provide retirement income for employees. The plan must meet certain requirements under the Internal Revenue Code and ERISA to be afforded special tax-favored treatment.

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