11 Saving for Retirement

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Planning for Tax Law Changes

- Modified AGI limits for traditional and Roth IRA contributions have been increased for 2015. See *Applicable Tax Law,* page 11-6 and page 11-11.
- The maximum compensation limit on which contributions can be based has increased from $260,000 to $265,000 for 2015. The maximum annual contribution limit for a participant in SEP and qualified defined contribution plans has increased from $52,000 to $53,000 for 2015.

Saving for Retirement Planning Strategies

Following is a summary of planning strategies used in this Tab.

- Qualified retirement plans provide for a current-year tax deduction. Earnings grow tax free while they remain inside the plan. Tax is not due until funds are withdrawn. Saving for retirement using qualified retirement plans allows the taxpayer to defer tax on earnings until needed for retirement. See *Qualified Retirement Plans Save Tax,* page 11-4.
- Defined contribution plans allow employers the ability to provide retirement benefits to employees without guaranteeing the amount payable at retirement. Thus, the only cost to the employer is the initial contribution. The employer is not at risk for the future investment performance. See *Qualified Retirement Plans Save Tax,* page 11-4.
- Defined benefit plans predetermine payouts that an employee is entitled to upon retirement. They are not subject to the deduction limits that apply to defined contribution plans. Thus, they can help an older business owner catch up on retirement planning to meet a certain retirement goal. See *Qualified Retirement Plans Save Tax,* page 11-4.

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Saving for Retirement Planning Strategies continued

- Elective deferrals through 401(k) type plans allow the participants to decide how much compensation they want contributed to the plan on a pre-tax basis. The employee is able to reduce taxable compensation by the amount the employee elects to defer. Some employers also offer some kind of matching contribution to those who choose to participate. See *Qualified Retirement Plans Save Tax,* page 11-4.
- IRAs, SEP IRAs, and SIMPLE IRAs are retirement plans that avoid the complex rules, red tape, and expensive administration costs that apply to qualified retirement plans. Employees are always 100% vested in the contributions, have control over the types of investments, and have the ability to withdraw funds at any time without having to wait for some event, such as death, disability, or separation from service. See *IRAs, SEPs, and SIMPLE Plans,* page 11-6.
- An employer that does not want to adopt a formal retirement plan can allow its employees to contribute to an IRA through payroll deductions. The decision about whether to contribute, how much to contribute and when is always made by the employee, with no cost or obligation on the employer. See *IRAs, SEPs, and SIMPLE Plans,* page 11-6.
- To get around the complex actual deferred percentage (ADP) and actual contribution percentage (ACP) tests that apply to traditional 401(k) plans, an employer may want to consider a safe harbor 401(k), which can be implemented by an employer of any size. A safe harbor 401(k) plan does not limit elective deferrals for highly-compensated employees, which is a benefit for a business owner who is the highly-compensated employee. See *Safe Harbor and Solo 401(k) Plans,* page 11-9.
- Self-employed taxpayers should consider the benefits of a solo 401(k) plan. The ADP and ACP tests are deemed to be met with no other employees to compare. Thus, the solo 401(k) plan allows the small business owner to defer a greater percentage of income into his or her retirement plan than any other type of qualified defined contribution plan. See *Safe Harbor and Solo 401(k) Plans,* page 11-9.
- When comparing the immediate tax deduction of a traditional IRA to the future tax-free distributions from a Roth IRA, a Roth IRA is more attractive the longer it has time to grow. Thus, a Roth IRA may be better for younger taxpayers, while older taxpayers benefit from contributing to a traditional IRA. See *Roth IRAs vs. Traditional IRAs,* page 11-11.
- Taxpayers expecting tax increases in the future may want to pay the tax currently on funds built up inside their traditional IRAs by converting to a Roth IRA to take advantage of future tax-free distributions of Roth IRA earnings. See *Roth IRA Conversion Decision,* page 11-13.

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2015 Retirement Plan Comparison

	Payroll Deduction IRA	SEP	SIMPLE IRA Plan	Safe Harbor 401(k)
Key Advantage	Easy to set up and maintain.	Easy to set up and maintain.	Salary reduction plan with little administrative paperwork.	Permits high level of salary deferrals by employees without annual discrimination testing.
Employer Eligibility	Any employer with one or more employees.	Any employer with one or more employees.	Any employer with 100 or fewer employees that does not currently maintain another retirement plan.	Any employer with one or more employees.
Employer's Role	Arrange for employees to make payroll deduction contributions. Transmit contributions for employees to IRA. No annual filing requirement for employer.	May use IRS Form 5305-SEP to set up the plan. No annual filing requirement for employer.	May use IRS Forms 5304-SIMPLE or 5305-SIMPLE to set up the plan. No annual filing requirement for employer. Bank or financial institution handles most of the paperwork.	No model form to establish this plan. Advice from a financial institution or employee benefit adviser may be necessary. A minimum amount of employer contributions is required. Annual filing of Form 5500 is required.
Contributors to the Plan	Employee contributions remitted through payroll deduction.	Employer contributions only.	Employee salary reduction contributions and employer contributions.	Employee salary reduction contributions and employer contributions.
Maximum Annual Contribution (per participant) *See www.irs.gov/ep for annual updates*	$5,500 for 2015. Additional contributions up to $1,000 can be made by participants age 50 or over.	Up to 25% of compensation [1] but no more than $53,000 for 2015.	*Employee:* $12,500 in 2015. Additional contributions up to $3,000 can be made by participants age 50 or over. *Employer:* Either match employee contributions 100% of first 3% of compensation (can be reduced to as low as 1% in any two out of five years) or contribute 2% of each eligible employee's compensation. [2]	*Employee:* $18,000 in 2015. Additional contributions can be made by participants age 50 or over up to $6,000. *Employer/Employee Combined:* Up to the lesser of 100% of compensation [1] or $53,000 for 2015. Employer can deduct (1) amounts that do not exceed 25% of aggregate compensation for all participants and (2) all salary reduction contributions.
Contributor's Options	Employee can decide how much to contribute at any time.	Employer can decide whether to make contributions year-to-year.	Employee can decide how much to contribute. Employer must make matching contributions or contribute 2% of each employee's compensation.	Employee can decide how much to contribute pursuant to a salary reduction agreement. The employer must make either specified matching contributions or a 3% contribution to all participants.
Minimum Employee Coverage Requirements	There is no requirement. Can be made available to any employee.	Must be offered to all employees who are at least 21 years of age, employed by the employer for three of the last five years and had compensation of at least $550 for 2015.	Must be offered to all employees who have earned income of at least $5,000 in any prior two years and are reasonably expected to earn at least $5,000 in the current year.	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Withdrawals, Loans, and Payments	Withdrawals permitted any time, subject to federal income taxes; early withdrawals subject to an additional tax (special rules apply to Roth IRAs).	Withdrawals permitted any time, subject to federal income taxes; early withdrawals subject to an additional tax.	Withdrawals permitted any time, subject to federal income taxes; early withdrawals subject to an additional tax.	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.), subject to federal income taxes. Plan may permit loans and hardship withdrawals; early withdrawals subject to an additional tax.
Vesting	Contributions are immediately 100% vested.	Contributions are immediately 100% vested.	Employee salary reduction contributions and employer contributions are immediately 100% vested.	Employee salary reduction contributions and most employer contributions are immediately 100% vested. Some employer contributions may vest over time according to plan terms.

[1] Maximum compensation on which 2015 contributions can be based is $265,000.
[2] Maximum compensation on which 2015 employer 2% nonelective contributions can be based is $265,000.

2015 Retirement Plan Comparison

	Automatic Enrollment 401(k)	Traditional 401(k)	Profit Sharing	Defined Benefit
Key Advantage	Provides high level of participation and permits high level of salary deferrals by employees. Also safe harbor relief for default investments.	Permits high level of salary deferrals by employees.	Permits employer to make large contributions for employees.	Provides a fixed, pre-established benefit for employees.
Employer Eligibility	Any employer with one or more employees.	Any employer with one or more employees.	Any employer with one or more employees.	Any employer with one or more employees.
Employer's Role	No model form to establish this plan. Advice from a financial institution or employee benefit adviser may be necessary. Annual filing of Form 5500 is required. Some plans require annual nondiscrimination testing to ensure they do not discriminate in favor of highly-compensated employees.	No model form to establish this plan. Advice from a financial institution or employee benefit adviser may be necessary. Annual filing of Form 5500 is required. Requires annual non-discrimination testing to ensure plan does not discriminate in favor of highly-compensated employees.	No model form to establish this plan. Advice from a financial institution or employee benefit adviser may be necessary. Annual filing of Form 5500 is required.	No model form to establish this plan. Advice from a financial institution or employee benefit adviser would be necessary. Annual filing of Form 5500 is required. An actuary must determine annual contributions.
Contributors to the Plan	Employee salary reduction contributions and maybe employer contributions.	Employee salary reduction contributions and maybe employer contributions.	Annual employer contribution is discretionary.	Primarily funded by employer.
Maximum Annual Contribution (per participant) *See www.irs.gov/ep for annual updates*	*Employee:* $18,000 in 2015. Additional contributions can be made by participants age 50 or over up to $6,000. *Employer/Employee Combined:* Up to the lesser of 100% of compensation [1] or $53,000 for 2015. Employer can deduct (1) amounts that do not exceed 25% of aggregate compensation for all participants and (2) all salary reduction contributions.	*Employee:* $18,000 in 2015. Additional contributions can be made by participants age 50 or over up to $6,000. *Employer/Employee Combined:* Up to the lesser of 100% of compensation [1] or $53,000 for 2015. Employer can deduct (1) amounts that do not exceed 25% of aggregate compensation for all participants and (2) all salary reduction contributions.	Up to the lesser of 100% of compensation [1] or $53,000 for 2015. Employer can deduct amounts that do not exceed 25% of aggregate compensation for all participants.	Annually determined contribution.
Contributor's Options	Employees, unless they opt otherwise, must make salary reduction contributions specified by the employer. The employer can make additional contributions, including matching contributions as set by plan terms.	Employee can decide how much to contribute pursuant to a salary reduction agreement. The employer can make additional contributions, including matching contributions as set by plan terms.	Employer makes contribution as set by plan terms.	Employer generally required to make contribution as set by plan terms.
Minimum Employee Coverage Requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Withdrawals, Loans, and Payments	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.), subject to federal income taxes. Plan may permit loans and hardship withdrawals; early withdrawals subject to an additional tax.	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.), subject to federal income taxes. Plan may permit loans and hardship withdrawals; early withdrawals subject to an additional tax.	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.), subject to federal income taxes. Plan may permit loans and hardship withdrawals; early withdrawals subject to an additional tax.	Payment of benefits after a specified event occurs (e.g. retirement, plan termination, etc.). Plan may permit loans; early withdrawals subject to an additional tax.
Vesting	Employee salary reduction contributions are immediately 100% vested. Employer contributions may vest over time according to plan terms.	Employee salary reduction contributions are immediately 100% vested. Employer contributions may vest over time according to plan terms.	May vest over time according to plan terms.	May vest over time according to plan terms.

[1] Maximum compensation on which 2015 contributions can be based is $265,000.
[2] Maximum compensation on which 2015 employer 2% nonelective contributions can be based is $265,000.

Saving for Retirement Planning Strategies continued from page 11-1

- Taxpayers who want to pass their IRAs on to their beneficiaries may want to convert their traditional IRAs and pension plans to Roth IRAs, which are not subject to the required minimum distribution (RMD) rules. See *Roth IRA Tax Planning for Older Taxpayers,* page 11-15.
- Low-income taxpayers should consider pulling money out of traditional IRAs or converting to a Roth IRA tax free to take advantage of the unused zero percent tax bracket or the lower 10% tax bracket. See *Tax-Free IRA Withdrawals,* page 11-18.
- Taxpayers may be eligible for the Retirement Savings Contribution Credit, or saver's credit, by making contributions to an employer-sponsored retirement plan or to an IRA. See *Retirement Savings Contribution Credit,* page 11-20.
- A taxpayer in good health should consider purchasing a life insurance policy that will provide a death benefit to the spouse should the taxpayer's death leave the spouse without a continuing pension payout. See *Life Insurance Retirement Planning,* page 11-23.

Qualified Retirement Plans Save Tax

Cross References

- IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*
- IRS Pub. 575, *Pension and Annuity Income*
- IRC §401, *Qualified pension, profit-sharing, and stock bonus plans*

Tax Issue

Despite the fact that America is one of the most prosperous nations, most find it difficult to save for the future. A 2006 survey found that 22% of Americans have no money left once they have paid for their essential living expenses and spent their discretionary dollars. A 2015 survey found that 57% of workers said they have less than $25,000 in savings and 28% of workers said they have less than $1,000 in savings.

Statistics like these illustrate that saving for retirement is low on the list of financial priorities. The government encourages taxpayers to save for retirement by providing tax incentives for qualified retirement savings plans.

Applicable Tax Law

- A qualified retirement plan is a plan provided by an employer that (1) provides retirement income to employees or results in the deferral of income by employees for periods extending generally to the end of employment or beyond, and (2) meets certain requirements under the Internal Revenue Code that give the plan its qualified status. A retirement plan that fails to meet either of these two requirements is a nonqualified retirement plan.
- A qualified retirement plan must be for the exclusive benefit of employees or their beneficiaries. Employer contributions are generally tax deductible on the employer's tax return and excluded from the employee's wages. Employee contributions reduce the employee's taxable compensation. Contributions and earnings are generally tax free until distributed.
- A defined contribution plan is a qualified plan that provides an individual account for each participant in the plan. Benefits paid to the participant depend upon the amount contributed to the plan over the years, plus income earned or losses sustained while the funds are in the plan. Examples of defined contribution plans include profit-sharing plans, money-purchase plans, 401(k) plans, and 403(b) plans.
- A defined benefit plan is any qualified plan that is not a defined contribution plan. Contributions are based on what is needed to provide determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions.

- A qualified defined contribution plan can include a cash or deferred arrangement under which participants can choose to have part of their before-tax compensation contributed to the plan rather than receive the compensation in cash. This type of plan is known as a 401(k) plan, and the employee contributions are called elective deferrals. Employers can, but are not required to, make matching contributions.
- The employer's deduction for defined contribution plans is limited to 25% of combined wages for all participants (20% of net self-employment income after the one-half SE tax deduction in the case of a self-employed individual). For 2015, the total of employer and employee contributions cannot exceed $53,000 per employee.
- For 2015, the elective deferral limit for a participant under age 50 equals $18,000. [$12,500 for a SIMPLE 401(k).] The elective deferral limit for a participant age 50 or older equals $24,000. [$15,500 for a SIMPLE 401(k).]
- In addition to the deduction allowed for contributions to IRAs and qualified retirement plans, low-income taxpayers can claim a tax credit of 10% to 50% of the amount contributed to the plan. For example, a married taxpayer with AGI equal to $32,000 who contributes $2,000 to his or her 401(k) plan has his or her taxable income reduced by $4,000 and receives a tax credit equal to $1,000. See *Retirement Savings Contribution Credit,* page 11-20.

Tax Planning Strategies

How qualified retirement plans save tax. Contributions to a qualified retirement plan provide for a current-year tax deduction. Earnings grow tax free while they remain inside the plan. Tax is not due until funds from the

plan are withdrawn. Thus, saving for retirement using qualified retirement plans allows the taxpayer to defer paying tax on earnings until needed for retirement. Earnings that otherwise would have been spent paying taxes also remain in the account earning tax-deferred income. Tax savings are also realized when the tax rate on the deductible contribution is higher than the tax rate on the taxable withdrawal.

Tax benefits of defined contribution plans. Defined contribution plans allow employers the ability to provide retirement benefits to employees without guaranteeing the amount payable at retirement. Benefits payable on retirement depend on the amount that is contributed and the investment performance. They also allow elective deferral arrangements where employees defer money out of their own compensation rather than the employer having to fund the entire amount. If investment performance is less than expected, and/or employee elective deferrals are not adequate to meet the retirement needs of the employee, the employer is not required to make up the difference.

Tax benefits of defined benefit plans. A defined benefit plan predetermines a payout that an employee is entitled to upon retirement. The employer makes contributions in an amount needed to provide definitely determinable future benefits to plan participants. Rules required to maintain a defined benefit plan are complicated and may require continual professional help. Although defined contribution plans are more popular, small employers and sole proprietors may find their own current retirement savings inadequate with relatively few years left to save. Since defined benefit plans allow for deductible contributions at levels necessary to meet predetermined retirement benefits, business owners can generally defer greater amounts of income into their own retirement plans over a shorter period of time. Defined benefit plans are not subject to the deduction limits that apply to defined contribution plans.

Tax benefits of 401(k) and 403(b) plans. In addition to the benefits listed under defined contribution plans, 401(k) and 403(b) plans allow the participant to make elective deferrals out of compensation on a pre-tax basis. Thus, the employee is able to reduce taxable compensation by the amount the employee elects to defer. The participant is fully vested in the elective deferrals at all times. Another benefit is employers will often offer some kind of matching contributions for employee elective deferrals. Elective deferrals are also made through payroll withholding, which makes it easier for employees to save for retirement.

Examples

Example #1: Paul has a W-2 job and is in the 35% tax bracket. He elects to defer $10,000 of his wages into a 401(k). He saves $3,500 in tax during the year ($10,000 × 35%). Ten years later, Paul retires and withdraws the $10,000 to pay living expenses. During retirement, Paul is in the 15% tax bracket. Tax on the withdrawal is $1,500 ($10,000 × 15%). Paul saves $2,000 in taxes ($3,500 – $1,500) simply by deferring income through a qualified retirement plan from a high-tax bracket year to a low-tax bracket year. Paul also receives a benefit from the time value of money by deferring the payment of tax by 10 years.

Example #2: Ralph has a W-2 job that offers employees the option to elect to defer a portion of their wages into a 401(k) plan. Ralph's employer will match 10% of the employee's contribution to the plan. Ralph decides to elect to defer $10,000 of his wages into the 401(k). Ralph's employer contributes an additional $1,000 on behalf of Ralph ($10,000 × 10%). Ralph immediately has earned an extra $1,000 merely by participating in his employer's 401(k) plan. Had Ralph chosen not to participate, he would not have been entitled to the extra $1,000.

Example #3: Earl has a W-2 job and gets paid every Friday. He is in the 15% tax bracket. After buying groceries and paying bills, Earl has a habit of spending the rest of his money at the bar and the casino. Earl is not disciplined enough to save for the future. Earl's employer has a 401(k) plan that offers to match 10% of employee elective deferrals. Earl decides to defer $5,000 of his pay during the year into his 401(k). The money is withheld from his pay before Earl has a chance to spend it.

Earl saves $5,500 per year for the future ($5,000 deferral + $500 employer match). Earl may be able to adjust to the $81.73 reduction per pay check ($5,000 deferral – $750 tax savings ÷ 52 pay periods) that is being withheld and saved for his future.

Example #4: Ed is age 50 and self-employed with a net profit of $250,000 per year. He has squandered all of his income over the years with an expensive lifestyle without any kind of savings plan for retirement. He goes to a financial planner that tells him he needs to put aside $125,000 per year for the next 12 years to maintain his desired lifestyle after retirement. If Ed were to use a defined contribution plan to fund his retirement, the most he could deduct each year is $53,000. If Ed were to use a defined benefit plan to fund his retirement, the full $125,000 of contributions would be deductible each year.

Possible Risks

- A defined contribution plan does not guarantee a certain amount payable to the employee at retirement. Contributions and investment performance may not be adequate to meet the retirement needs of the employee.
- Qualified retirement plans can be complicated to set up and administer. An employer should seek the advice of a professional.

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- An employee generally has no access to funds until after the employee separates from the employer's service. In contrast, IRAs, SEPs, SIMPLEs, etc. are always 100% vested, with the employee having access to the funds at any time.
- Complexity and restrictions placed on highly-compensated employees make 401(k) type plans difficult and sometimes expensive to administer. Key employees do not always receive the full benefit of allowable elective deferrals. These restrictions do not apply to IRAs, SEPs, SIMPLEs, and certain safe harbor 401(k) plans.

Court Cases

Court Case: The taxpayer failed to report $45,955 in retirement plan distributions from a qualified retirement plan. The taxpayer admitted in court receiving the distributions from a defined contribution plan. However, the taxpayer contended that the distributed amounts should not be included on his return because his employer illegally cancelled his life insurance, cancelled his lifetime employment contract, said his savings would be lost, and said his savings were liquidated for safety as an involuntary conversion. The taxpayer contended that his dismissal was an illegal retaliatory act carried out to punish him for reporting various fraudulent acts. He claimed his employer plotted to have him killed for reporting fraudulent activity. He also claimed the issuance of the notice of deficiency from the IRS was a result of a conspiracy between his employer and the IRS to harass him for his whistleblowing. The court said there was no need to respond to such arguments with somber reasoning and copious citations of precedent. The taxpayer is a taxpayer subject to income tax. The court ruled the taxpayer failed to include the $45,955 in income. (*Smith,* T.C. Summary Opinion 2002-33, April 3, 2002)

IRAs, SEPs, and SIMPLE Plans

Cross References

- IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*
- IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*
- IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
- IRS Pub. 4334, *SIMPLE IRA Plans for Small Businesses*
- IRC §408, *Individual retirement accounts*
- IRC §408(k), *Simplified employee pension defined*

Tax Issue

Small employers and those with part-time or low-wage employees often provide little or no retirement benefits to employees. Low-paid employees typically are more concerned with their current cash flow problems and would prefer more current cash from the employer rather than tax-deferred retirement benefits. Small employers may also be less enthusiastic about maintaining a qualified retirement plan for employees that is expensive and burdensome to administer. Government regulations and red tape may make it difficult for a small employer trying to run a business to offer employees anything other than cash wages. A small business owner may also not know whether there will be a profit to fund a retirement plan until after the end of the year, in which case it may be too late to set up and fund a qualified retirement plan for himself or herself, and the employees. Non-discrimination rules for qualified retirement plans may discourage the business owner from offering a retirement plan to the employees, especially if the small business owner is older than the typical employee and the only person currently interested in saving for retirement.

For reasons such as these and others, a small business owner may be reluctant to set up a retirement plan for employees.

Applicable Tax Law

IRA applicable rules:

- The IRA contribution limit in 2015 for a participant under age 50 is the lesser of 100% of a participant's compensation for the year, or $5,500 ($6,500 for participants age 50 or older).
- Contributions cannot be made in a year the participant has reached age 70½, or for any later year.
- A deduction for the IRA contribution may be reduced or phased out if the participant is an active participant in an employer-sponsored pension plan.
- Contributions to an IRA must be made by the tax return due date, not including extensions, for filing the tax return of the participant.

SEP IRA applicable rules:

- The SEP IRA contribution limit in 2015 is the lesser of 100% of a participant's compensation for the year, or 25% of wages up to $53,000 (20% of net SE income after the one-half SE tax deduction up to $53,000 for self-employed individuals).
- The employer, and not the employee, makes deductible contributions to the employee's SEP IRA. An employer cannot withhold the contribution from the employee's W-2 wage (other than SARSEPs established by employers prior to 1997).
- Employers must contribute the same percentage of compensation to the accounts of all eligible employees. If the employer is self-employed and contributes to his or her own SEP, the same percentage has to be contributed to the accounts of all eligible employees of the self-employed individual.
- Employers cannot discriminate against any employee that has reached age 21, has worked for the employer in at least three of the immediately preceding five years,

and has received at least $550 in compensation from the employer during the preceding year.

- A SEP IRA can be set up and funded as late as the due date, including extensions, for filing the tax return for the year the contribution applies.

SIMPLE IRA applicable rules:

- The SIMPLE IRA elective deferral limit in 2015 for a participant under age 50 is the lesser of 100% of a participant's compensation for the year, or $12,500 ($15,500 for participants age 50 or older). The employer must match dollar for dollar up to 3% of the participant's earned income, or elect to match 2% of wages for all employees (including nonparticipants). If the 2% match is elected, the matching contribution cannot exceed $5,300 per employee. If the 3% match is elected, the employer can elect a lower percentage, but not lower than 1%, for any two out of five years.
- Eligible employers can set up a SIMPLE IRA for employees if they have 100 or fewer employees who received $5,000 or more in compensation from the employer in the preceding year.
- An eligible employer cannot maintain another qualified plan.
- Any employee who received at least $5,000 in compensation from the employer during any two years prior to the current year, and reasonably expects to receive at least $5,000 in compensation during the current year, must be allowed to participate in the employer's SIMPLE plan.
- A self-employed individual is treated as both an employee and the employer of his or her business.
- A SIMPLE IRA can be set up effective on any date from January 1 through October 1 of a year, provided the employer did not previously maintain a SIMPLE IRA plan.
- A SIMPLE IRA must be set up for an employee before the first date a contribution is required to be deposited into the employee's IRA. Employers must contribute the salary reduction amounts to the SIMPLE IRA of an employee within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. Employer-matching contributions are due by the due date, including extensions, for filing the tax return.

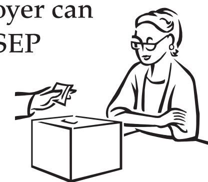
Tax Planning Strategies

IRAs, SEP IRAs, and SIMPLE IRAs are retirement plans that avoid the complex rules, red tape, and expensive administration costs that apply to qualified retirement plans. IRA-type plans can be set up rather quickly and for little or no administrative costs. Employees benefit because they are always 100% vested in the contributions, have control over the types of investments, and have the ability to withdraw funds at any time without having to wait for some event, such as death, disability, or separation from service. Employers benefit because the rules are simple, administration expenses are low or nonexistent, and the decision on how much to contribute can generally be made on a year-to-year basis at the time the employer's tax return is prepared.

Individual retirement arrangement (IRA). Any individual can set up an IRA if he or she receives taxable compensation during the year and is not age 70½. If an employer does not offer a retirement plan for the employees, an employee is free to fund his or her own retirement plan in the form of making IRA contributions. If an employer does not want to make any retirement plan contributions on behalf of employees, but wishes to fund his or her own retirement plan, the employer can set up and contribute to his or her own IRA.

Payroll-deduction IRA. An employer that may not want to adopt a formal retirement plan can allow its employees to contribute to an IRA through payroll deductions. The plan can be made available to any employee. The decision about whether to contribute, how much to contribute and when is always made by the employee. The employer merely arranges for the payroll deductions and transmits the employee's contributions to their IRA.

Simplified employee pension (SEP). A SEP plan provides a simplified method for employers to make contributions to a retirement plan on behalf of its employees. The employer adopts a written SEP agreement and makes contributions to a traditional individual retirement account (SEP IRA) set up for each eligible employee. A SEP IRA is owned and controlled by the employee, and the employer makes contributions to the financial institution where the SEP IRA is maintained. SEP IRAs have low start-up and operating costs. The employer can decide how much (if any) to put into a SEP IRA each year, giving the employer flexibility when business conditions vary.



A SEP IRA is ideal for business owners who cannot make a retirement plan contribution decision until the last minute. The SEP IRA can be set up and funded as late as the tax return deadline, including extensions. Thus, the decision to fund the SEP IRA can be made after the tax return results are known.

Savings incentive match plan for employees (SIMPLE). A SIMPLE IRA is a retirement plan that allows eligible employees to contribute a percentage of their wages each paycheck, with a minimal amount of matching contributions required from the employer. Using employee elective deferrals to fund the majority of contributions to the plan makes a SIMPLE IRA similar to a 401(k), without the complex ADP and ACP testing that applies to 401(k) plans.

Examples

Example #1: Russ is self-employed with no employees. Each year he does not know where he is at financially until he does his bookkeeping for the year. He procrastinates and files for an extension to file his tax return each year. By the time he finally does his books in August, it is too late to make an IRA contribution for the previous year or to set up a qualified retirement plan for himself. He learns on August 26, 2015, that his 2014 net profit from self-employment after the one-half SE tax deduction equals $80,000, which puts him in the 25% federal tax bracket. He decides on that date to contribute the maximum amount ($80,000 × 20% = $16,000) to a SEP for 2014, which saves him $4,000 ($16,000 × 25%) in federal income taxes for 2014.

Example #2: Greg owns a small business with 10 full-time employees, not counting himself. He is incorporated as an S corporation and is in the 25% federal tax bracket on his individual tax return. He is interested in offering his employees a retirement plan, but he prefers most of the contributions come from employee compensation rather than out of his own pocket. He is also interested in something not very complicated where he doesn't have to pay a financial advisor to administer his retirement plan. Greg sets up a SIMPLE IRA plan for each of his employees who choose to participate and offers to match each employee's elective deferrals up to 3% of their compensation. Assume eight out of 10 employees choose to participate. The eight participating employees each average $50,000 in wages and all choose to defer more than $1,500 of their wages into their SIMPLE IRA. Greg's out-of-pocket cost (not counting anything he chooses to contribute for himself) for offering the plan is $9,000 [$50,000 × 3% = $1,500: $1,500 × 8 = $12,000: $12,000 – $3,000 ($12,000 × 25%) = $9,000].

Example #3: Assume the same facts as Example #2, except that Greg decides to match 2% of wages for all 10 employees, including the two who do not elect to defer any wages. Assume average wage for all 10 employees is $50,000. Greg's out-of-pocket cost (not counting anything he chooses to contribute for himself) for offering the plan is $7,500 [$50,000 × 2% = $1,000: $1,000 × 10 = $10,000: $10,000 – $2,500 ($10,000 × 25%) = $7,500].

Example #4: Sam owns a small business with 10 full-time employees, not counting himself. He is incorporated as an S corporation. He is interested in contributing toward his own retirement and is also interested in offering his employees a retirement plan, but does not wish to contribute any additional money on behalf of his employees other than what he is currently paying them as wages. Sam sets up a payroll deduction IRA plan for all employees who choose to participate. Each employee is free to choose to have an amount automatically withheld from his or her paycheck on an after-tax basis and contributed to his or her IRA, up to his or her maximum allowable IRA contribution for the year. Each employee that participates is then allowed to claim an IRA deduction on his or her individual tax return, based upon that individual employee's qualifications for claiming an IRA deduction for the year.

Possible Risks

- If the taxpayer contributes to a traditional IRA in addition to his or her participation in an employer-sponsored retirement plan, a portion or all of his or her IRA contributions may be nondeductible. The basis in a nondeductible traditional IRA must be mixed in with all other traditional IRA funds. The tax-free basis cannot be fully distributed until all funds in all traditional IRAs have been depleted. In this situation, the taxpayer should instead consider contributing to a Roth IRA.
- A taxpayer cannot contribute to a traditional IRA for the year in which he or she reaches age 70½.
- Contribution limits for an IRA are generally lower than that allowed for other types of retirement plans.
- A SEP IRA is entirely funded by employer contributions. The employees do not elect to contribute compensation to the plan. A SEP IRA can be very expensive for a small business owner with many employees.
- A SIMPLE IRA must be set up by October 1 of the year contributions are to apply. The taxpayer cannot wait until filing the tax return for the year to decide whether or not to set up a SIMPLE IRA for that year.
- A SIMPLE IRA has lower elective deferral limits than a 401(k). A small business owner with no employees should instead consider a solo 401(k) or a SEP IRA. A small business owner with only a few employees should instead consider a safe harbor 401(k). See *Safe Harbor and Solo 401(k) Plans,* page 11-9.

Court Cases

Court Case: The IRS denied the taxpayer's deduction for contributions made to the taxpayer's SIMPLE IRA. The taxpayer was an employee of Total Lighting Sales, Inc. Total Lighting Sales, Inc. established a qualified SIMPLE IRA for its eligible employees. The taxpayer deposited $9,000 and $10,500 to his SIMPLE IRA in 2003 and 2004. Total Lighting Sales, Inc. did not reduce the taxpayer's salary to fund the deposits or make contributions on the taxpayer's behalf. Instead, the taxpayer made the deposits using funds drawn from his personal savings account. The taxpayer claimed deductions on his 2003 and 2004 individual tax returns for the amounts deposited into his SIMPLE IRA.

In court, the taxpayer conceded that his lump-sum deposits did not constitute valid contributions within the meaning of IRC section 408(p). Instead, the taxpayer argued that the tax implications would have been the same had the contributions been made through a salary deduction. This is because contributions under a qualified salary reduction arrangement

are made before tax. By using after-tax money from a savings account and then deducting a corresponding amount, the same result is achieved and the IRS is no worse off after this lump-sum contribution than they would have been had the money been withheld monthly from the taxpayer's paychecks. The taxpayer argued that he should not be penalized for making an honest mistake.

The court sympathized with the taxpayer's position. However, the court noted such equitable arguments cannot overcome the plain meaning of the statute. Such issues are in the province of Congress, and the court is not authorized to rewrite the statute. The court ruled in favor of the IRS. *(Forret,* T.C. Summary Opinion 2007-165, September 24, 2007)

Court Case: The taxpayer was an active participant in his employer's qualified retirement plan. He contributed $6,983 to the plan during the year in question. The taxpayer's spouse was also an active participant in her employer's qualified retirement plan. She contributed $192.87 to her plan during the year in question. She also contributed $5,000 to her IRA and deducted the contribution on the couple's joint federal tax return. The IRS denied the IRA deduction because both husband and wife were active participants in qualified plans and their AGI exceeded the phase-out provisions for deducting IRA contributions [IRC §219(g)]. During the audit, the taxpayers attempted to change the wife's status as an active participant in a qualified plan by submitting an amended return reporting the $192.87 employee contribution as income.

In court, the taxpayers did not dispute that they were active participants in their employer's qualified retirement plan. Instead, they asserted that the law affects them unfairly since the very small contribution to the wife's qualified plan results in a much greater disallowance of the IRA contribution deduction and adversely affects their ability to save for retirement. The court noted that under the law, even de minimis participation is sufficient to render a taxpayer an active participant. The court must enforce the laws as written and interpreted. While the result to the taxpayers seems harsh, the court cannot ignore the plain language of the statute and, in effect, rewrite the statute to achieve what would appear to be an equitable result. The court ruled the taxpayers were each an active participant in a qualified retirement plan and as such subject to the IRA deduction limitations. *(Gallant,* T.C. Summary Opinion 2012-7)

Safe Harbor and Solo 401(k) Plans

Cross References

- IRS Pub. 3998, *Choosing a Retirement Solution for Your Small Business*
- IRS Pub. 4222, *401(k) Plans for Small Businesses*
- IRC §401(k), *Cash or deferred arrangements*

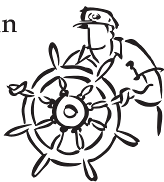
Tax Issue

Small employers and sole proprietors often shy away from 401(k) plans due to the complex ADP and ACP tests that apply (actual deferral percentage and actual contribution percentage tests). These tests are designed to prevent discrimination against lower-paid employees by not allowing highly-compensated employees to elect to defer a greater percentage of compensation into their 401(k). Since business owners of small businesses are usually the highly-compensated employees, a small business owner may prefer instead to use an IRA, SEP IRA, SIMPLE IRA, or SIMPLE 401(k) plan to save for retirement, which do not require ADP and ACP testing. The problem with using an IRA-type of retirement plan is an IRA, SEP, or SIMPLE does not allow the small business owner to defer as much compensation into his or her retirement plan as does a 401(k) plan.

Applicable Tax Law

- The maximum elective deferrals that an employee can contribute to his or her 401(k) plan for 2015 is $18,000 for participants under age 50 and $24,000 for participants age 50 or older.
- An employer's deduction for contributing to a 401(k) for 2015 is limited to 25% of combined wages for all participants before reducing wages for elective deferrals (20% of net SE income after the one-half SE tax deduction in the case of a self-employed individual). The total of employer and employee contributions cannot exceed $53,000 per employee.
- ***Actual deferral percentage (ADP).*** Actual deferral percentage equals the percentage of compensation that an employee elects to defer into his or her 401(k) plan.
- A 401(k) plan satisfies the ADP test if (1) the ADP for the highly-compensated employees is not more than the ADP for the nonhighly-compensated employees multiplied by 1.25, or (2) the excess of the ADP for the highly-compensated employees over the ADP for the nonhighly-compensated employees is not more than 2%, and the ADP for the highly-compensated employees is not more than the ADP for the nonhighly-compensated employees multiplied by 2.
- ***Actual contribution percentage (ACP).*** Actual contribution percentage equals the percentage of compensation that is actually contributed to an employee's 401(k) plan. This includes the employee elective deferrals plus employer-matching contributions.
- The ACP test uses the same multiples and percentages found in the ADP test to determine if the 401(k) plan satisfies the ACP test.
- If a 401(k) plan meets the safe harbor 401(k) plan rules, the plan does not have to pass the ADP and ACP tests.
- Unlike a traditional 401(k) plan, a safe harbor 401(k) plan must provide for employer-matching contributions that are fully vested at all times.

- A safe harbor 401(k) plan can be combined with other retirement plans (unlike SIMPLE plans where the employer cannot have any other plans).
- A safe harbor 401(k) plan must meet minimum employer-matching rules. The employer can match each eligible employee's elective deferrals dollar-for-dollar (100%), up to 3% of the employee's compensation, and 50¢ on the dollar (50%) for the employee's elective deferrals that exceed 3%, but not more than 5% of the employee's compensation.



- Alternatively, a safe harbor 401(k) plan meets the minimum employer-matching rules if the employer makes nonelective contributions equal to 3% of the compensation to each eligible employee's account, including those employees who are eligible to participate but do not elect to make any elective deferrals into their 401(k) plan.
- The minimum employer-matching rules for safe harbor 401(k) plans are a minimum employer-matching formula. The employer can set up an enhanced matching formula in which the employer matches 100% of employee elective contributions up to an amount greater than 3% of compensation as long as the formula is at least as great as the 3% to 5% formula mentioned above, and the general $53,000 per employee 2015 contribution limit that applies to all qualified retirement plans is not exceeded.
- A 401(k) plan set up for a sole proprietor (including a husband and wife business) with no other employees is called a solo 401(k) plan. With no other employees, the sole participant is deemed to have satisfied both the ADP test and the ACP test, thus allowing the sole proprietor to contribute the maximum possible amount allowed for any defined contribution plan.
- A highly-compensated employee is an individual who owned more than 5% of the interest in the taxpayer's business, regardless of compensation, or, received compensation from the taxpayer more than $120,000.

Tax Planning Strategies

Employers. To get around the complex ADP and ACP tests that apply to traditional 401(k) plans, an employer may want to consider a safe harbor 401(k). A safe harbor 401(k) can be used by an employer of any size. If the employer has already agreed to make matching contributions for employees, the matching contribution formula under the safe harbor 401(k) rules may be very similar to the amounts the employer has already agreed to contribute. Even if the matching contributions under the safe harbor rules are more than what the employer would like to contribute, the fact that highly-compensated employees are not limited under the ADP and ACP test may be enough to offset the higher-matching formula, especially if the business owner is the highly-compensated employee.

Self-employed taxpayers. If the small business owner has no other employees, the self-employed individual should set up a solo 401(k) plan. The ADP and ACP tests are deemed to be met with no other employees to compare. A solo 401(k) plan allows the small business owner to defer a greater percentage of income into his or her retirement plan than any other type of qualified defined contribution plan.

Examples

Example #1: Tammy is under age 50 and is a self-employed author. She collects royalties from a publisher who published her novel. Her husband, Corey, also works, and they pay most of their bills with his salary alone. They wish to put away as much as possible to a qualified retirement plan for Tammy. She sets up a single-participant solo 401(k) plan for herself. Her net profit after the one-half SE tax deduction is $30,000. She contributes the maximum elective deferral of $18,000 to the plan. The ADP and ACP tests have no effect on her elective deferrals as there are no other employees. The plan is also set up to contribute the maximum employer deduction allowed under IRC section 404(a)(3), which is 25% for employees, or 20% for self-employed individuals. Since elective deferrals do not reduce compensation for purposes of the IRC section 404(a)(3) deduction limit, her employer-matching contribution is $6,000 ($30,000 × 20%). The total of employer contributions ($6,000) plus elective deferrals ($18,000) equals $24,000, which is 80% of her total self-employment earnings.

Example #2: Assume the same facts as Example #1, except that Tammy is age 54. She contributes the maximum elective deferral of $24,000 to the plan, plus $6,000 of employer contributions for a total of $30,000, or 100% of her total self-employment earnings.

Example #3: Assume the same facts as Example #2, except that it is April 15 and Tammy only has time to set up an IRA or a SEP IRA. The maximum she can contribute to a SEP IRA for 2015 is $6,000, or 20% of her total self-employment earnings. Instead, Tammy could contribute up to $6,500 to a traditional IRA.

Possible Risks

- Safe harbor 401(k) plans and solo 401(k) plans are still qualified retirement plans, subject to the written plan requirement, ERISA requirements (other than solo 401(k) plans which are not subject to ERISA), vesting rules, and Form 5500 series reporting requirement rules.
- Small business owners often make last minute decisions on making IRA or SEP contributions. An IRA or SEP can be set up and funded in a matter of a few minutes by simply showing up at a bank or other financial institution. If the business owner makes the decision to fund a retirement plan on the filing deadline date for

making such contributions, it is probably too late to go through the formalities required to set up a safe harbor 401(k) or solo 401(k) plan.

Court Cases

Court Case: The taxpayer owned his own CPA firm. He was sole trustee of its 401(k) plan. He caused the 401(k) to lend funds to three companies in which he was the largest stockholder (9% to 33%), but not the controlling stockholder. The taxpayer signed the loan checks for the 401(k) and signed the notes for the borrowers. All loans were repaid in full.

The IRS contended that the 401(k) loans constituted a prohibited transaction within the meaning of IRC section 4975. The taxpayer acknowledged that he was a disqualified person with regard to the 401(k) because he owned the CPA firm. However, he believed (1) none of the corporations that were the borrowers were a disqualified person, (2) none of the loans were a transaction between him and the 401(k), and (3) he did not benefit from the loans, either in income or in his own account.

The IRS maintained that the plan loans were prohibited transactions under IRC section 4975(c)(1)(D), transfer or use of plan assets for the benefit of a disqualified person, and IRC section 4975(c)(1)(E), dealing with plan assets for the fiduciary's own interest.

The Tax Court held that an IRC section 4975(c)(1)(D) prohibition did not require an actual transfer of money or property between the 401(k) and the disqualified person. The fact that a disqualified person could have benefited as a result of the use of plan assets was sufficient. The Tax Court held that the loan transactions were uses by the CPA firm, or for the taxpayer's benefit, of assets of the 401(k). These assets of the 401(k) were not transferred to the CPA firm. As to each of the transactions, the CPA firm sat on both sides of the table. The CPA firm made the decisions to lend the 401(k) funds, and the CPA firm signed the promissory notes on behalf of the borrowers. The court said this flies in the face of the general thrust of the legislation to stop disqualified persons from dealing with the relevant employee's 401(k) or the 401(k) assets. The Tax Court held the loans to be self-dealing since the taxpayer couldn't prove the loans were not a use of the 401(k) assets for his own benefit. *(Rollins,* T.C. Memo 2004-260, November 15, 2004)

Roth IRAs vs. Traditional IRAs

Cross References

- IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*
- IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
- IRC §219(g), *Limitation on deduction for active participants in certain pension plans*
- IRC §408, *Individual retirement account*
- IRC §408A, *Roth IRAs*

Tax Issue

The tax issues surrounding Roth IRAs versus traditional IRAs can be confusing. A traditional IRA can provide an immediate tax benefit in that contributions are generally tax deductible, while contributions to a Roth IRA are not. The tax benefit for contributing to a Roth IRA is a future tax benefit in that earnings can eventually be distributed tax free, while distributions from a traditional IRA are usually taxable. To complicate the issue even further, depending upon the taxpayer's circumstances, the deduction for contributing to a traditional IRA may be phased out, and subsequent distributions may be partially tax free as a return of basis. Thus, the decision on contributing to a Roth IRA versus a traditional IRA is a decision based on facts and circumstances. The answer depends on the number of years left before retirement, the AGI of the taxpayer, the current tax bracket of the taxpayer, and the expected tax bracket when distributions from the IRA begin.

Applicable Tax Law

- Annual contribution limits are the same for both Roth IRAs and traditional IRAs. For 2015, the contribution limit is $5,500 for taxpayers under age 50 and $6,500 for taxpayers age 50 or older.
- Contributions to a Roth IRA are nondeductible. Traditional IRA contributions may be deductible.
- Allowable contributions to Roth IRAs are phased out in 2015 when modified AGI is between $183,000 – $193,000 for MFJ and $116,000 – $131,000 for Single and HOH. Roth IRA phaseouts apply regardless of whether a taxpayer is an active participant in an employer-sponsored pension plan.
- The deduction for contributions to a traditional IRA are phased out in 2015 if the taxpayer is an active participant in an employer-sponsored pension plan, and modified AGI is between $98,000 – $118,000 for MFJ, and $61,000 – $71,000 for Single and HOH.
- Distributions from a traditional IRA are generally taxable. Qualified distributions from a Roth IRA are tax free if the participant has held a Roth IRA for at least five years, and the distribution is due to:
  a) The participant being over age 59½,
  b) Death or disability of the participant, or
  c) A qualified first-time home purchase.
- Contributions can no longer be made to a traditional IRA for the year the taxpayer turns age 70½. Contributions to a Roth IRA are allowed even when the taxpayer is over age 70½, provided the taxpayer still has earned income.

continued on next page

- Required minimum distribution (RMD) rules apply to taxpayers who are at least 70½ with funds in a traditional IRA. The RMD rules do not apply to Roth IRAs.
- A beneficiary inherits funds in a Roth IRA tax free.

Tax Planning Strategies

Younger taxpayers. When comparing the immediate tax deduction of a traditional IRA to the future tax-free distributions from a Roth IRA, a Roth IRA is more attractive the longer it has time to grow. Thus, a younger taxpayer with many years left before retirement may want to consider contributing to a Roth IRA instead of a traditional IRA.

Older taxpayers. If the taxpayer only has a few years left before retirement, a deductible contribution to a traditional IRA may be more attractive than a future tax-free distribution of earnings from a Roth IRA, especially if the taxpayer is in a higher tax bracket during his or her working years versus retirement years.

Working taxpayers over age 70½. If the taxpayer continues to work past age 70½ and wishes to continue to make IRA contributions, the Roth IRA is the only option. See *Roth IRA Tax Planning for Older Taxpayers,* page 11-15.

High income taxpayers. If the taxpayer's AGI is above the phase-out range for making Roth IRA contributions, a contribution to a traditional IRA may be the only option. Even if the active participation rules make the traditional IRA contributions nondeductible, the funds contributed can still grow tax free inside the IRA. Once inside the traditional IRA, the high-income taxpayer can then convert the traditional IRA into a Roth IRA.

Examples

Example #1: Nathan is single and age 30. After roughing out his 2015 tax return, Nathan is due a federal tax refund of $3,000. The refund is without making any IRA or pension plan contributions for 2015. Nathan is in the 15% federal tax bracket, and his AGI is below both the traditional IRA and Roth IRA AGI phase-out ranges. Since it is still early in the tax filing season, Nathan is advised that he could make an IRA contribution for 2015 and receive the tax refund in enough time before the April 15 deadline to help fund an IRA with his refund.

Nathan chooses to contribute $5,000 to a Roth IRA for 2015. He receives no tax benefit for the contribution in 2015 so his federal tax refund remains at $3,000. The $5,000 contribution is invested in a fund that has a growth rate of 4% per year for the next 30 years, when Nathan turns age 60. After 30 years (April 15, 2046), the $5,000 grows to $16,217. This money is available for Nathan to withdraw tax free.

Example #2: Assume the same facts as Example #1, except that Nathan chooses to contribute $5,000 to a traditional IRA. After 30 years (April 15, 2046), the $5,000 grows to $16,217. Assume in that year, Nathan is still in the 15% federal tax bracket. After withdrawing the funds and paying tax, he is left with $13,784 [$16,217 – ($16,217 × 15%)].

However, for 2015, Nathan also receives an increased federal tax refund of $750 ($5,000 × 15%) due to the fact that the traditional IRA contribution was deductible. Assume Nathan takes that extra $750 and invests it in a taxable investment fund that has a growth rate of 4% per year for the next 30 years, with annual withdrawals taken each year to pay tax on the earnings (assume 15% tax bracket each year). The $750 will grow after taxes to $2,045 after 30 years (April 15, 2046). Nathan now has $15,829 of after-tax money ($13,784 + $2,045).

Thus, with everything else being equal, Nathan will have $388 ($16,217 – $15,829) more in after-tax money by choosing to contribute to a Roth IRA versus a traditional IRA.

Example #3: Assume the same facts as Example #1, except that Nathan is age 48 and in the 25% federal tax bracket. After 12 years (April 15, 2028), when Nathan turns age 60, the $5,000 grows to $8,005, which is available for Nathan to withdraw tax free.

Example #4: Assume the same facts as Example #3, except that Nathan chooses to contribute the $5,000 to a traditional IRA. After 12 years (April 15, 2028), the $5,000 grows to $8,005. Assume in that year, Nathan's tax bracket drops from the 25% federal tax bracket to the 15% federal tax bracket. After withdrawing the funds and paying tax, he is left with $6,804 [$8,005 – ($8,005 × 15%)].

However, in 2015, Nathan also receives an increased federal tax refund of $1,250 ($5,000 × 25%) due to the fact that the traditional IRA contribution was deductible. Assume Nathan takes that extra $1,250 and invests it in a taxable investment fund that has a growth rate of 4% per year for the next 12 years, with annual withdrawals taken each year to pay tax on the earnings (assume 25% tax bracket each year). After 12 years (April 15, 2028), the $1,250 will grow after taxes to $1,782. Nathan now has $8,586 of after-tax money ($6,804 + $1,782).

Thus, with everything else being equal in Examples #3 and #4, Nathan will have $581 ($8,586 – $8,005) more in after-tax money by choosing to contribute to a traditional IRA versus a Roth IRA.

Possible Risks

- The general idea of using a Roth IRA for younger taxpayers and a traditional IRA for older taxpayers may not apply if the taxpayer wishes to continue to work past age 70½ and continue to make retirement plan contributions, or the taxpayer does not want the required minimum distribution rules to force distributions to be

taken after age 70½. See *Roth IRA Tax Planning for Older Taxpayers*, page 11-15.
- Taxpayers may not know what their tax bracket will be in the future when they plan on withdrawing funds from their IRAs. As illustrated in the examples starting in the next columnt, making a tax planning decision today for something that is expected to happen dozens of years into the future requires assumptions that really cannot be known for certain.
- State tax laws may not follow federal tax laws concerning Roth IRA tax-free earning rules.
- Congress could conceivably change its mind on allowing substantial tax-free wealth building up inside a Roth IRA. Tax planning that takes 20 years to develop may be too much of a risk to count on.

Roth IRA Conversion Decision

Cross References

- IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*
- IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
- IRC §408, *Individual retirement account*
- IRC §408A, *Roth IRAs*

Tax Issue

The decision to convert a traditional IRA to a Roth IRA is complex and entails many variables and considerations, including taxpayers' current and future marginal income tax rates, age, net worth, income needs, investment time horizon, and estate tax considerations.

The most apparent disadvantage of the Roth IRA conversion is the immediate income tax that must be paid upon conversion, and that future tax-free benefits are long term and hard to measure.

The advantage of a Roth IRA conversion is that over time, the after-tax time value of money with a Roth IRA conversion eventually overtakes the after-tax time value of money leaving the funds inside a traditional IRA. Wealthy taxpayers who will not need IRA distributions in retirement may benefit from a Roth IRA conversion since there are no mandatory distribution requirements with a Roth IRA. Also, without mandatory distribution requirements, low-income taxpayers who decide to leave their funds inside a Roth IRA may have a lower AGI and may possibly avoid taxable Social Security benefits and loss of other tax benefits and credits that are based on AGI.

Applicable Tax Law

- Money rolled over or directly transferred from a traditional IRA into a Roth IRA is called a conversion contribution. The distribution from the traditional IRA is taxable to the extent it does not represent a return of nondeductible basis. A conversion contribution is not subject to the 10% early withdrawal penalty.
- An amount distributed from a traditional IRA to meet RMD rules does not qualify for conversion into a Roth IRA.
- An inherited traditional IRA from someone other than a spouse cannot be converted into a Roth IRA.
- The tax paid on conversion is based on the FMV of the IRA immediately prior to the conversion.
- Money in an employer-sponsored retirement plan, such as a 401(k), 403(b), or profit-sharing plan, may be directly converted to a Roth IRA, subject to the same rules that apply to IRA to Roth IRA conversions.
- Married taxpayers filing separate can also roll over amounts from eligible retirement plans to Roth IRAs.

Tax Planning Strategies

Expecting a future tax bracket increase. Taxpayers who expect tax increases in the future may want to pay the tax currently on funds built up inside their traditional IRAs by converting to a Roth IRA rather than defer paying tax until a future year in which it will be subject to a higher tax rate, especially since future earnings can be withdrawn tax free.

Many years before retirement. Taxpayers who have many years before needing their IRA funds may want to convert their traditional IRAs and pension plans to Roth IRAs. Over time, the future tax benefit of being able to withdraw earnings tax free will overtake the current tax benefit of deferring tax on traditional IRA contributions.

Taxpayers who want to pass their IRAs on to their beneficiaries. Taxpayers who wish to pass their IRAs to their beneficiaries may want to convert their traditional IRAs and pension plans to Roth IRAs. Funds in a traditional IRA eventually must be distributed to taxpayers under the RMD rules. Funds in a Roth IRA are not subject to the RMD rules. Inherited funds from a Roth IRA can be distributed to the beneficiaries tax free if the 5-year holding period requirement is met.

Examples

Example #1: Tom is age 45 and has an existing traditional IRA valued at $20,000. He is currently in the 28% combined federal and state tax bracket. He converts the IRA to a Roth IRA. Tax on the conversion is $5,600 ($20,000 × 28%). No further contributions are made to the Roth IRA which earns 8% annually. At age 65, Tom's Roth IRA will have a balance of $93,219 which is available to distribute tax free.

Since Tom used after-tax income to pay the $5,600 tax on the conversion, the future value of that money needs to be subtracted from the $93,219 accumulated in the Roth IRA when Tom is age 65. If Tom could have earned 8% annually on that

money, the future value of it would be $17,164 at age 65 (8% annual earnings less 28% tax on the earnings paid annually). Thus, by currently having to pay tax on the conversion, the future value of the Roth IRA distribution at age 65 is actually $76,055 ($93,219 – $17,164).

Example #2: Assume the same facts as Example #1, except that Tom leaves the $20,000 in his traditional IRA. At age 65, his traditional IRA will have the same balance of $93,219. However, it is fully taxable when he begins to take distributions. Tax on $93,219 (assuming he remains in the 28% tax bracket) is $26,101, leaving him with $67,118 in after-tax funds ($93,219 – $26,101).

Thus, by not converting his traditional IRA into a Roth IRA, Tom will have $8,937 less in after-tax funds ($76,055 – $67,118).

Example #3: Assume the same facts as Example #1, except that Tom is age 55 and in the 31% combined federal and state tax bracket when he converts his traditional IRA to a Roth IRA. Assume that he drops from the 31% bracket to a 15% combined federal and state bracket when he retires at age 65 and begins to take distributions from the Roth IRA. Tax on the conversion is $6,200. His Roth IRA grows to $43,178 when Tom is age 65. The future value of the tax on the conversion is $10,609. Thus, the future value of the Roth IRA distribution at age 65 is $32,569 ($43,178 – $10,609).

Example #4: Assume the same facts as Example #3, except that Tom leaves the $20,000 in his traditional IRA. Tax on the traditional IRA equals $6,477 ($43,178 × 15%), leaving him with $36,701 in after-tax funds ($43,178 – $6,477). Thus, by not converting his traditional IRA into a Roth IRA, Tom will have $4,132 more in after-tax funds ($36,701 – $32,569).

Possible Risks

- Taxpayers may not know what their tax bracket will be in the future when they plan on withdrawing funds from their IRAs. Making a tax planning decision today for something that is expected to happen dozens of years into the future requires assumptions that really cannot be known for certain.
- Taxpayers should examine the effects of a Roth IRA conversion on the present and future taxability of Social Security benefits, marginal tax rate increases, and possible loss of valuable tax credits which are phased out based on AGI (for example, the Earned Income Credit, Child Tax Credit, education credits, etc.).
- State tax laws may not follow federal tax laws concerning Roth IRA earnings and conversion rules.
- Congress could conceivably change its mind on allowing substantial tax-free wealth building up inside a Roth IRA. Tax planning that takes 20 years to develop may be too much of a risk to count on.

Court Cases

Court Case: The taxpayer paid a $120,000 fee to an investment adviser for a scheme to convert approximately $1.3 million in a traditional IRA into a Roth IRA without paying any tax on the conversion. The so-called tax-free conversion was done through a series of complicated corporate formations, transfers, and mergers in an attempt to avoid taxes and disguise excess contributions to the taxpayer's Roth IRA. The taxpayer's returns were eventually audited by the California Franchise Tax Board, with the California Franchise Tax Board concluding that the taxpayer did not owe any additional taxes.

Later, the taxpayer received a letter from his investment adviser that said the Roth restructure was legal, but that he might want to disclose on his income tax returns the structure. The taxpayer attached Form 8886, *Reportable Transaction Disclosure Statement,* to his tax return with little information concerning the transaction. The taxpayer timely filed Form 1040 for all years at issue. Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts,* was not filed for any years at issue.

The IRS eventually issued a notice of deficiency for the years at issue, including three tax years that were beyond the statute of limitations. The IRS could not assess any tax on the original conversion because tax on Roth IRA conversions is reported directly on Form 1040. Since Form 1040 was timely filed, the statute of limitations on issuing a notice of deficiency for the year of conversion had expired. Instead, the IRS claimed the money that eventually found its way into the Roth IRA was an excess contribution. As an excess contribution, the 6% penalty (plus interest) under IRC section 4973 applies each year the approximate $1.3 million remained in the taxpayer's Roth IRA. The IRS also assessed the penalty for failure to file Form 5329 (the form that reports the 6% penalty) under IRC section 6651(a)(1).

The taxpayer argued in court that the statute of limitations bars the IRS from assessing deficiencies for three of the years at issue. The taxpayer presented no evidence to establish that he did not make an excess contribution to his Roth IRA. Instead, he claimed Form 5329 is not a separate tax return from Form 1040, and therefore the statute of limitations started running when he filed his timely Form 1040 returns for each year. The IRS claimed Form 5329 is a separate tax return from Form 1040 and that since the taxpayer never filed Form 5329 for any year, the statute of limitations had not yet started to run.

The court agreed with the IRS. Filing Form 1040 does not start the running of the statute of limitations for purposes of excise taxes imposed on Form 5329. The court ruled the taxpayer was liable for the IRC section 4973 excise tax deficiencies and the penalty imposed under IRC section 6651(a)(1) for all years at issue. *(Paschall,* 137 .. No. 2, July 5, 2011)

✎ **Author's Comment:** The IRS conceded that if the court held the taxpayer liable for the 6% excess Roth IRA contribution penalty, then any later distribution from the Roth IRA is not taxable as a distribution from a traditional IRA.

Roth IRA Tax Planning for Older Taxpayers

Cross References

- Form 5498, *IRA Contribution Information*
- IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*
- IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
- IRC §219(g), *Limitation on deduction for active participants in certain pension plans*
- IRC §408A, *Roth IRAs*

Tax Issue

A taxpayer cannot make traditional IRA contributions for the year he or she reaches age 70½ even if he or she continues to work and has earned income. If a taxpayer is a participant in a traditional IRA and has reached age 70½, he or she must begin taking distributions from the traditional IRA under the required minimum distribution (RMD) rules. The economy and volatility of the stock market may contribute to an older taxpayer's desire and need to find tax-advantage ways of maximizing retirement savings.

Applicable Tax Law

- Contributions to a Roth IRA are nondeductible.
- Contributions are limited to the lesser of $5,500 ($6,500 if age 50 or older) or taxable compensation.
- When both spouses have compensation, each can set up a separate Roth IRA. If Married Filing Jointly, and one spouse's compensation is less than the contribution limit, the lower-income spouse can use the compensation of the other spouse to qualify.

- Contributions to a Roth IRA can be made after the participant reaches age 70½.
- Contributions phase out for 2015 when modified AGI is $183,000 to $193,000 for Married Filing Jointly or Qualifying Widow(er), $116,000 to $131,000 for Single, Head of Household, or Married Filing Separately, where both spouses lived apart at all times during the year, and $0 to $10,000 for Married Filing Separately, where both spouses lived together.
- The RMD rules do not apply to Roth IRAs. Distributions are not required until death of the participant. At the death of the Roth IRA participant, the RMD rules apply to the beneficiary as though the Roth IRA owner died before his or her required beginning date. Distributions from an inherited Roth IRA are tax free unless the Roth IRA participant did not meet the 5-year holding period requirement for contributions or conversions.
- Taxpayers can exclude from gross income qualified distributions or distributions that are a return of regular contributions from the Roth IRA.
- Distributions come out of a Roth IRA in the following order: (1) contributions, (2) conversions, (3) earnings.
- Distributions from contributions are tax free and penalty free until total distributions exceed total contributions.
- Distributions come next from conversion contributions on a first-in first-out basis. Distributions are tax free to the extent the converted amount was taxed upon conversion, plus any basis from nondeductible contributions. Distribution of converted amounts are penalty free if held in the Roth IRA for at least five years or one of the early withdrawal penalty exceptions apply.
- Distributions come last from earnings, only after all contributions and conversions are distributed. Taxation of earnings depends on whether the distribution is a qualified distribution or a nonqualified distribution.
- Qualified distributions are tax free if the participant has held a Roth IRA for five years and the distribution is due to: (1) the participant is over age 59½, (2) death or disability of the participant, or (3) qualified first-time homebuyer.
- Nonqualified distributions are taxable and subject to the 10% early withdrawal penalty unless an exception applies.

Tax Planning Strategies

Roth IRAs provide a means for taxpayers who want or need to work past age 70½ to continue to build and preserve retirement savings. Since there is no age restriction for contributions and no minimum distribution requirement, investing in a Roth IRA may be a good idea for a taxpayer expecting to work past planned retirement age. A Roth IRA can allow a worker extending their career to continue to build tax-favored retirement savings while receiving Social Security benefits. A Roth IRA also provides the taxpayer the security of holding onto his or her retirement funds as long as necessary without having to take required minimum distributions.

Examples

Example: Ralph is age 71 and has decided to work for five more years. He expects to earn $20,000 per year. Ralph decides he will contribute $6,000 into a Roth IRA for each year he is working. The contribution will be made at the beginning of each year into a certificate of deposit earning 2% compounded annually. At the end of five years, Ralph will have contributed $30,000 ($6,000 × 5) to the Roth IRA. The earnings in the Roth IRA will accumulate tax free, and the value of the account at the end of five years will be $31,849. After five years, any distributions Ralph takes from his Roth IRA are nontaxable and will not affect the amount of his Social Security benefits that may be taxed. Ralph is also not required to take any distributions from his Roth IRA which will continue to grow tax free.

Since Ralph is past full retirement age, his earnings do not decrease his monthly Social Security benefit. The Social Security Administration will review Ralph's earnings records every year to determine whether the additional earnings will increase his monthly benefit.

Possible Risks

- A taxpayer in need of medical assistance may need to "spend-down" his or her assets to qualify for Medicaid. Contributing to a Roth IRA after planned retirement age may increase the taxpayer's assets subject to any potential "spend-down."
- A taxpayer near retirement age may have many health issues. If a taxpayer becomes unable to work for any reason and has no earned income, he or she will not be able to make a contribution to a Roth IRA for that year.
- Roth IRAs may be invested in a variety of investment options, including mutual funds, stocks, and bonds which are subject to market risk.
- An older taxpayer who is still employed with an employer that offers 401(k) matching benefits may want to consider taking full advantage of maxing out his or her 401(k) contributions before contributing to a Roth IRA. The after-tax distributions from a 401(k) that represent the employer's matching contribution could be greater than the tax-free benefit of taking a Roth IRA distribution.
- Rather than contributing to a Roth IRA, a taxpayer in good health at age 71 may qualify for a greater life insurance benefit than conservative earnings from a Roth IRA invested in a certificate of deposit. See *Author's Comment,* below.

✎ **Author's Comment:** Assume in the example, above, that Ralph intends to have his beneficiaries inherit his Roth IRA as he does not ever anticipate needing the money for his own retirement needs. He is considering the Roth IRA as a vehicle for him to accumulate wealth for his beneficiaries.

However, if he is in good health at age 71, Ralph may qualify for an even greater benefit by purchasing a universal life insurance policy. For example, assume Ralph, at age 71, qualifies for $60,000 of life insurance with a premium of $3,000 per year. If he over-contributes to his universal life policy by contributing $6,000 per year for the next five years, the earnings from the universal life policy should be able to continue to pay the cost of the policy for many years after the five-year contribution period ends. The payout from the life insurance will exceed accumulated Roth IRA funds, assuming Ralph dies before his accumulated Roth IRA exceeds $60,000.

Recharacterize a Roth Conversion When Value Decreases

Cross References

- Form 5498, *IRA Contribution Information*
- IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*
- IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
- IRC §408, *Individual retirement accounts*
- IRC §408A, *Roth IRAs*

Tax Issue

There are several reasons why a taxpayer may want to convert a traditional IRA into a Roth IRA. Taxpayers who expect tax increases during retirement years may want to pay the tax currently at a lower rate rather than defer it to a year in which it will be subject to a higher tax rate. A taxpayer who has many years left before needing the retirement benefits may want to consider a Roth conversion because Roth IRA distributions are tax free when certain conditions are met, thus allowing tax-deferred earnings to be distributed tax free.

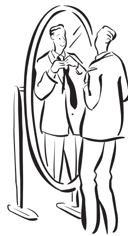
One drawback to converting a traditional IRA into a Roth IRA is that tax on a conversion is determined by using the fair market value of the IRA at the time it is converted to a Roth IRA. If the value decreases after the date of conversion, the taxpayer is paying tax on an amount greater than the current value of the IRA.

Applicable Tax Law

- Money distributed from a qualified plan or IRA and reinvested within 60 days into a Roth IRA is called a conversion contribution. The distribution is taxable to the extent it does not represent a return of nondeductible basis.
- A conversion contribution can also be accomplished through a trustee-to-trustee transfer, or a same trustee transfer where the trustee simply redesignates a tradi-

tional IRA as a Roth IRA rather than open up a new account or issue a new contract.

- The tax paid on conversion is based on the FMV of the IRA or employer plan immediately prior to the conversion.
- A recharacterized conversion treats the conversion as if it had not occurred. A recharacterized contribution treats the contribution as having been originally made to the second IRA instead of the first IRA.
- To recharacterize a contribution, the taxpayer must transfer the money in a trustee-to-trustee transfer from the first IRA (the one to which it was made) to the second IRA. A trustee-to-trustee transfer can include a trustee that simply redesignates the first IRA as the second IRA.
- The recharacterization must be made by the due date, including extensions, for the tax year in which the original contribution was made. However, if the taxpayer timely filed the return without making the transfer, the transfer can be made within six months of the due date of the return, excluding extensions, by filing an amended return reflecting the transfer.
- The recharacterization must include any net income or loss allocable to the contribution. Any income or loss that occurred in the first IRA will be treated as having occurred in the second IRA.
- The recharacterization is reported on the tax return for the year during which the contribution was made.



- A recharacterization treats the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.
- An election to recharacterize can be made on behalf of a decedent by the executor, administrator, or other person responsible for filing the decedent's final return.
- When a traditional IRA is converted into a Roth IRA, then recharacterized as a traditional IRA, then converted back into a Roth IRA, it is called a reconversion.
- A taxpayer cannot reconvert before (1) the beginning of the year following the year in which the amount was originally converted into a Roth IRA or, if later, (2) the end of the 30-day period beginning on the day on which the amount was transferred from the Roth IRA back to a traditional IRA in a recharacterization.

Tax Planning Strategies

Whenever a taxpayer converts a traditional IRA into a Roth IRA, the taxpayer should monitor the fair market value of the IRA and recharacterize the conversion if FMV decreases within the allotted time allowed for recharacterizations. By recharacterizing the Roth IRA back to a traditional IRA, the taxpayer can null and void the tax due on the over-inflated value of the IRA. The taxpayer can then reconvert the IRA back to a Roth IRA and pay tax on the lower value. Thus, a Roth conversion should never be considered a completed transaction until the time period for doing a recharacterization and reconversion has expired.

Example

Example: Steve converts a traditional IRA to a Roth on October 1, 2015. As of that date, the value of the IRA was $10,000. Steve files for an extension on his 2015 tax return. The $10,000 fair market value as of October 1, 2015, is taxed on the 2015 return. On August 15, 2016, the value of the Roth IRA decreases to $2,000. Steve no longer wants to pay tax on $10,000 on the 2015 return. Steve has the option to recharacterize the Roth IRA as a traditional IRA as of October 1, 2015. In other words, it is treated as if Steve never did a Roth conversion on October 1, 2015, and Steve no longer has to add $10,000 of income to the 2015 return. After the recharacterization on August 15, 2016, the taxpayer now has the option to reconvert the traditional IRA to a Roth IRA using $2,000 as the taxable conversion amount rather than $10,000.

Possible Risks

- If the decrease in value occurs after the deadline for recharacterizing the conversion, the taxpayer is stuck paying tax on the higher amount.
- If the Roth IRA earns little or no income between the time of conversion and the time of distribution, the taxpayer needlessly accelerated paying tax on IRA funds that represented tax-deferred earnings prior to the conversion.
- A Roth conversion could cause other income, such as Social Security benefits, to be taxable in the year of conversion.

Court Cases

Court Case: The taxpayer argued that a Roth conversion should not cause Social Security benefits to be taxable. The taxpayer stated: "The rollover doesn't create income. A distribution would create income, but a rollover doesn't. You don't get any money. And from a simplistic point of view, there's the difference between not getting money and getting money. When the law was passed with reference to taxability of Social Security benefits, they referred to income. And, I think they meant actual income. Money that you got, not a mythical amount of money that you didn't get. There is a big difference between getting money and not getting money. And, I don't think my Social Security benefits should be taxed based on money I didn't get. Yes, as far as taxing the rollover, it is a taxable rollover. But it is not a distribution." The court disagreed with the taxpayer's contention. The conversion was taxable income which caused the taxpayer's Social Security benefits to be taxable. *(Helm,* T.C. Summary Opinion 2002-138, October 18, 2002)

Tax-Free IRA Withdrawals

Cross References

- Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*
- Form 5498, *IRA Contribution Information*
- IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*
- IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
- IRC §408, *Individual retirement accounts*
- IRC §408A, *Roth IRAs*

Tax Issue

The conventional wisdom on a traditional IRA is to leave money in the IRA as long as possible to gain the benefit of tax deferral. Taxpayers can defer withdrawals on IRAs until age 70½.

A taxpayer whose income is in a low tax bracket, or is not subject to income tax because of personal exemptions and standard or itemized deductions, can withdraw money from an IRA and pay little or no income tax on the distribution.

Applicable Tax Law

- Taxpayers must take required minimum distributions (RMD) by April 1 of the calendar year following the year in which the taxpayer reaches age 70½.
- The standard deduction for 2015 is:
  - Single or MFS .... $ 6,300
  - MFJ or QW $12,600
  - Head of Household .... $ 9,250
- The additional standard deduction amounts for age 65 or older and/or blind, per person per event in 2015 are:
  - MFJ, QW, or MFS $1,250
  - Single or Head of Household $1,550
- The personal exemption per person for 2015 is $4,000.
- Distributions from conversion amounts in a Roth IRA taken within five years of the conversion are subject to 10% additional tax. Distributions of conversion amounts to disabled taxpayers and taxpayers over age 59½ are not subject to the 10% additional tax.

Tax Planning Strategies

Taxpayers older than 59½, and those under age 59½ who are disabled and qualify for an exemption from the 10% additional tax on IRA withdrawals, should review taxable income every year to determine what amount, if any, can be distributed from an IRA without incurring tax on the distribution.

Income. Taxpayers who need additional income can use the tax-free distributions to supplement Social Security and pension income. See *Example #1,* below.

Roth conversion. If taxpayers don't need the distribution for living expenses, a Roth conversion would benefit the taxpayer by doing a potential tax-free conversion. The benefit of tax deferral would continue to be in place for the taxpayer. The Roth conversion would benefit the taxpayer in the current year and in the future years when the eventual RMDs need to be taken. See *Example #2,* page 11-19.

A Roth conversion could also be done after a taxpayer begins taking his or her RMD. The key factor with this is that the taxpayer must take his or her RMD prior to converting any amount to a Roth IRA. See *Example #3,* page 11-19.

Taxable conversion. A taxpayer may want to consider converting money from an IRA to a Roth even if his or her taxable income is in the 10% bracket. Although the conversion would not be tax free, the taxpayer could benefit by having contributed to the IRA in past years when the taxpayer was likely subject to a higher tax rate and would now be paying a lower percentage of tax on the amount converted. In addition, the eventual beneficiary would benefit by receiving a tax-free death benefit from the Roth IRA instead of a taxable distribution from the deceased person's traditional IRA (if 5-year holding period requirement is met).

Examples

Example #1: Steve and Linda, both age 62, are receiving Social Security income of $1,100 each per month. Steve also receives a $400 pension monthly. They do not have any additional taxable income. Linda does not have a pension but does have an IRA. They need additional income of $800 monthly to live on. Linda can take a monthly distribution of $800 from her IRA and it will not be subject to tax. They file a joint return for 2015.

Taxable income:		
Steve's pension	$ 4,800	
Taxable Social Security benefits	$ 0	
Linda's IRA distribution	$ 9,600	
Total taxable income		$14,400
Less:		
Standard deduction	$12,600	
Personal exemptions	$ 8,000	
Total deduction and exemption		$20,600
Taxable income		$ (6,200)

Steve and Linda could take an additional $6,200 from Linda's IRA and still not be taxed on the distribution. Steve and Linda need to be careful, however, that their pension and IRA income plus one-half of their Social Security does not exceed $32,000. If this occurs, part of their Social Security could be added to taxable income.

Example #2: Maureen is age 64 and is living comfortably on her Social Security income of $1,700 per month and a pension of $500 per month. She has $150,000 in an IRA. She does not want to take any withdrawals from her IRA until she is 70½. However, Maureen could convert $4,300 in 2015 from her IRA to a Roth IRA, and the conversion would not be taxable to Maureen.

Taxable income:

Pension	$6,000	
IRA conversion to Roth IRA	$4,300	
Total taxable income		$10,300

Less:

Standard deduction	$6,300	
Personal exemption	$4,000	
Total deduction and exemption		$10,300
Taxable income		$ 0

Because of the conversion of $4,300 to the Roth IRA, Maureen now has $145,700 in her traditional IRA. The Roth IRA will grow tax deferred, and the conversion amount can be withdrawn at any time. Earnings on the growth of the Roth IRA can be withdrawn tax free after five years from the conversion date. Without making the Roth conversion, the $4,300 tax-free amount ($10,300 total of standard deduction and personal exemption minus $6,000 pension income) goes unused for the year.

This gives Maureen options for tax-free income for 2016. First, assuming her income does not change in 2016, she will continue to have an amount she can take from her IRA without being taxed. Also, she can withdraw $4,300 from her Roth conversion IRA tax free.

Assuming the same level of growth would occur in the IRA with or without the conversion, the IRA will have a lesser amount to compute Maureen's eventual RMD from.

Example #3: In 2015, Louis, who is single, turned age 73. The balance of his IRA on December 31, 2014 was $100,000. Using the uniform lifetime table, his RMD for 2015 is $4,049. Louis has no other taxable income. Louis has $7,801 of additional income he can take from his IRA and not pay tax on it. If he does not want or need $7,801 as income, he should convert this amount to a Roth IRA.

Standard deduction	$ 7,850
Personal exemption	$ 4,000
	$11,850
Less RMD	(4,049)
Amount available to convert	$ 7,801

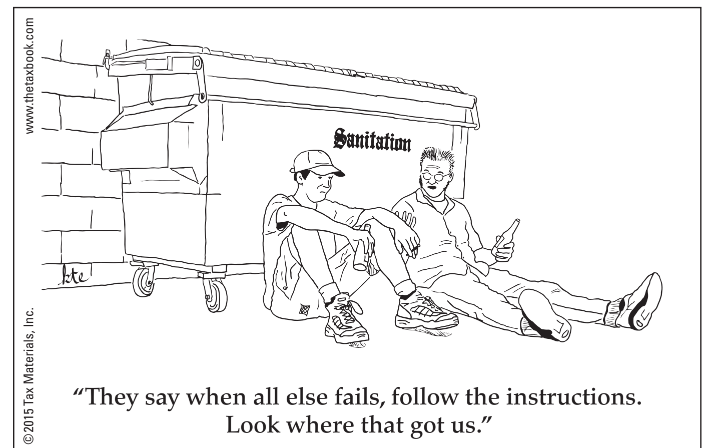
Louis has created three additional tax benefits by converting the $7,801.

1) He has a source of tax-free income in future years by withdrawing the converted amount from his Roth IRA.
2) He has established a tax-free death benefit in the Roth IRA for his beneficiaries.
3) He has reduced the IRA balance that will be used to determine his 2016 RMD. If, for some reason, his tax situation is different in 2016 and his RMD is taxable, a smaller RMD amount would reduce his tax burden for 2016. If his 2016 tax situation is similar to 2015, the amount determined by adding his standard deduction plus personal exemption and subtracting his RMD will result in a tax-free amount for him to convert to his Roth IRA again.

✎ **Author's Comment:** By planning IRA distributions in advance and then taking those distributions strategically, a taxpayer can maximize the benefit of owning an IRA. For taxpayers with lower incomes, this can give the added benefit of getting a tax deduction throughout the working years and not paying taxes on the amount withdrawn. In addition, IRA conversions made while a taxpayer is not subject to income tax have the added benefit of converting pre-tax contributions to future tax-free income and tax-free death benefits. Taxpayers whose income is subject to higher income tax brackets can also benefit by planning IRA withdrawals strategically.

Possible Risks

- IRA distributions need to be planned in advance so a taxpayer needs to have a good idea of his or her taxable income by early December to leave enough time to process a distribution or conversion from an IRA.
- Careful calculation must be made to ensure taxpayers do not create taxable income by taking a distribution from an IRA or doing a conversion. A taxpayer's Social Security could become taxable.
- The rules for doing a conversion to a Roth IRA after age 70½ are very specific. In order to be eligible for a conversion, the amount must be eligible to be rolled over. Since an RMD is not eligible to be rolled over, only the amount distributed from an IRA after the RMD has been taken can be converted to a Roth IRA. Specifically, the RMD amount must be removed prior to the conversion occurring.



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"They say when all else fails, follow the instructions. Look where that got us."

Retirement Savings Contribution Credit

Cross References

- Form 5498, *IRA Contribution Information*
- Form 8880, *Credit for Qualified Retirement Savings Contributions*
- IRC §25B, *Elective deferrals and IRA contributions by certain individuals*

Tax Issue

Taxpayers may be eligible for a tax credit if they make eligible contributions to an employer-sponsored retirement plan or to an individual retirement arrangement. The Retirement Savings Contribution Credit, also called the "saver's credit," can provide an additional incentive to save for retirement.

Applicable Tax Law

- A credit of 10-50% of eligible contributions to IRAs and retirement plans up to a maximum credit of $1,000 ($2,000 MFJ). The credit is nonrefundable and is limited to the net federal income tax due.
- 2015 credit rate based upon AGI is as follows:

Rate	MFJ	HOH	Single, QW, MFS
50%	$0 – $36,500	$0 – $27,375	$0 – $18,250
20%	$36,501 – $39,500	$27,376 – $29,625	$18,251 – $19,750
10%	$39,501 – $61,000	$29,626 – $45,750	$19,751 – $30,500
0%	over $61,000	Over $45,750	Over $30,500

- The credit is based on modified AGI which consists of AGI plus excluded income from Puerto Rico and income from residents of American Samoa.
- To be eligible, a taxpayer must:
  - Have attained age 18 by the close of the tax year,
  - Not be claimed as a dependent on someone else's tax return for the year, or
  - Not be a student during any part of five calendar months for the tax year.
- Eligible contributions made for the tax year include:
  - Traditional and Roth IRA contributions.
  - Elective deferrals to a 401(k), 403(b), governmental 457 plan, SEP, or SIMPLE plan.
  - Voluntary employee contributions to a qualified retirement plan as defined in IRC section 4974(c), including the Federal Thrift Savings Plan.
  - Contributions to a 501(c)(18)(D) plan.
- To figure the credit, contribution amounts are reduced by distributions from any of the plans listed, above, received from January 1, 2013, through the deadline for filing the 2015 return (including extensions). However, contributions are not reduced for any of the following distributions.
  - Rollovers and trustee-to-trustee transfers.
  - Traditional IRA to Roth IRA conversions.
  - Distributions of excess contributions/deferrals and earnings.
  - Loans from employer plans treated as distributions.
  - Returns of IRA and Roth IRA contributions if:
    1) The distribution is made by the due date for filing the return (including extensions),
    2) The contribution is not deducted, and
    3) The distribution includes the income on the contribution.
  - Dividend distributions on stock in an ESOP under IRC section 404(k).
  - Distributions from military retirement plans.
  - Distributions from an inherited IRA by a non-spousal beneficiary.

Tax Planning Strategies

Traditional or Roth IRA? Unlike employer-sponsored retirement plans, contributions to a traditional IRA or Roth IRA can be made for the 2015 tax year until April 15, 2016. This allows the taxpayer to take advantage of the saver's credit after the tax year has ended. The general belief is that taxpayers, especially younger taxpayers, should consider contributing to a Roth IRA for long-term tax benefits. This belief is especially strong for taxpayers whose current income is subject to the 15% tax rate or lower because it is assumed the taxpayer's income will increase in future years and the resulting tax rate at retirement will likely be higher than the current tax rate. However, taxpayers who qualify for the savers credit should take a closer look to see whether contributing to a traditional IRA and getting a current deduction is more beneficial.

How much to contribute. The saver's credit is based on AGI so a deductible traditional IRA contribution will reduce the taxpayer's AGI to a level that may qualify the taxpayer for the credit, or may qualify the taxpayer for a larger credit percentage. Even small amounts contributed to a traditional IRA may qualify the taxpayer for a substantially larger credit.

Contribution and distribution. For some taxpayers, a contribution and subsequent distribution may result in an additional tax benefit for one particular year. A distribution from a retirement account may limit the saver's credit for future years by reducing the future contribution by the distribution amount when figuring the saver's credit in the future. See *Applicable Tax Law,* previous column. However, if a taxpayer does not plan on making future contributions, a current year distribution will not result in decreased saver's tax credit. Therefore, a contribution and subsequent distribution can result in a saver's credit without keeping the contribution in the retirement account for an extended period of time. See Example #5, page 11-22.

Examples

Example #1: Vera is single and age 30. She is a nurse who, in most years, makes $80,000 on her regular schedule. In 2015, she significantly reduced her hours at the hospital so she could volunteer more often. Her 2015 W-2 shows $20,500 in wages. She did not contribute to her employer's retirement plan in 2015. She does not itemize deductions so her taxable income is $10,200 with a net tax liability of $1,073. Vera considers making a 2015 contribution of $3,000 to a Roth IRA. She is eligible for a $200 Retirement Savings Contribution Credit ($2,000 maximum contribution considered for the credit times 10% credit rate). Her current year net tax savings is 6.7% ($200 credit divided by $3,000 contribution amount). However, if she contributes $3,000 to a traditional IRA instead, the combination of reduced tax and increased Retirement Savings Contribution Credit eliminates her tax liability. Her current year net tax savings is 35.8% ($1,073 tax savings divided by the $3,000 contribution amount). Even though her credit is limited to the tax liability of $723, Vera makes a $3,000 contribution to lower her AGI to below the threshold needed to receive the 50% credit.

	No Retirement Contribution	$3,000 Traditional IRA Contribution	$3,000 Roth IRA Contribution
Income	$20,500	$20,500	$20,500
IRA Deduction	$0	($3,000)	$0
AGI	$20,500	$17,500	$20,500
Standard Deduction	($6,300)	($6,300)	($6,300)
Personal Exemption	($4,000)	($4,000)	($4,000)
Taxable Income	$10,200	$7,200	$10,200
Tax	$1,073	$723	$1,073
Saver's Credit	$0	($723)*	($200)
Tax after Saver's Credit	$1,073	$0	$873
Net Tax Savings vs. No Retirement Contribution		$1,073	$200

*Credit is limited to tax liability.

Example #2: Assume the same facts as Example #1, except that Vera is considering a contribution to a traditional IRA only. Vera compares the benefit of contributing $2,000 versus $3,000 to a traditional IRA. A $2,000 contribution reduces her AGI to $18,500. This reduces her tax liability from $1,073 to $823—a savings of $250. In addition, she receives a Retirement Savings Contribution Credit of $400 ($2,000 IRA contribution times 20% credit rate). This results in a current-year tax savings of $650 ($250 tax savings plus $400 credit). Her current year net tax savings is 32.5% ($650 tax savings divided by the $2,000 contribution amount).

If, instead, Vera contributes $3,000 to her traditional IRA, her AGI is reduced to $17,500 and she qualifies for the 50% tax credit. Her tax liability is reduced from $1,073 to $723—a savings of $350. Vera's Retirement Savings Contribution Credit is $723 ($2,000 maximum contribution considered for the credit times 50% credit rate equals $1,000, but the credit is limited to the amount of the tax liability). This results in a current-year tax savings of $1,073 ($350 tax savings plus $723 credit). Her current year net tax savings is 35.8% ($1,073 tax savings divided by the $3,000 contribution amount).

	No Retirement Contribution	$2,000 Traditional IRA Contribution	$3,000 Traditional IRA Contribution
Income	$20,500	$20,500	$20,500
IRA Deduction	$0	($2,000)	($3,000)
AGI	$20,500	$18,500	$17,500
Standard Deduction	($6,300)	($6,300)	($6,300)
Personal Exemption	($4,000)	($4,000)	($4,000)
Taxable Income	$10,200	$8,200	$7,200
Tax	$1,073	$823	$723
Saver's Credit	$0	($400)	($723)
Tax after Saver's Credit	$1,073	$423	$0
Net Tax Savings vs. No Retirement Contribution		$650	$1,073

Example #3: Assume the same facts as Example #1, except that Vera's W-2 shows $21,400 in wages. In considering a $3,000 traditional IRA contribution, Vera's tax liability would be reduced from $1,208 to $813—a savings of $395. Vera's Retirement Savings Contribution Credit is $400 ($2,000 maximum contribution considered for the credit times 20% credit rate). This results in a current-year tax savings of $795 ($395 tax savings plus $400 credit). Her current year net tax savings is 26.5% ($795 tax savings divided by the $3,000 contribution amount).

If, instead, Vera contributes $3,200 to her traditional IRA, her AGI is reduced to $18,200 and she qualifies for the 50% tax credit. Her tax liability is reduced from $1,208 to $793—a savings of $415. Vera's Retirement Savings Contribution Credit is $793 ($2,000 maximum contribution considered for the credit times 50% credit rate equals $1,000, but the credit is limited to the amount of the tax liability). This results in a current-year tax savings of $1,208 ($415 tax savings plus $793 credit). Her current year net tax savings is 37.8% ($1,208 tax savings divided by the $3,200 contribution amount). More specifically, the additional $200 traditional IRA contribution yields an additional $413 in tax savings (net tax savings of a $3,200 contribution of $1,208 minus net tax savings of a $3,000 contribution of $795).

continued on next page

Example #3 continued

	No Retirement Contribution	$3,000 Traditional IRA Contribution	$3,200 Traditional IRA Contribution
Income	$21,400	$21,400	$21,400
IRA Deduction	$0	($3,000)	($3,200)
AGI	$21,400	$18,400	$18,200
Standard Deduction	($6,300)	($6,300)	($6,300)
Personal Exemption	($4,000)	($4,000)	($4,000)
Taxable Income	$11,100	$8,100	$7,900
Tax	$1,208	$813	$793
Saver's Credit	$0	($400)	($793)
Tax after Saver's Credit	$1,208	$413	$0
Net Tax Savings vs. No Retirement Contribution		$795	$1,208

Example #4: A small IRA contribution can provide a substantial tax benefit to a taxpayer. David, a single taxpayer, has W-2 wages for 2015 of $17,500. He does not itemize deductions. By contributing $500 to a traditional IRA, he reduces his tax liability from $723 to $673, a savings of $50. Dave's Retirement Savings Contribution Credit is $250 ($500 contribution times 50% credit rate). This results in a current-year tax savings of $300 ($50 tax savings plus $250 credit). His current year net tax savings is 60.0% ($300 tax savings divided by the $500 contribution amount).

	No Retirement Contribution	$ 500 Traditional IRA Contribution
Income	$17,500	$17,500
IRA Deduction	$0	($500)
AGI	$17,500	$17,000
Standard Deduction	($6,300)	($6,300)
Personal Exemption	($4,000)	($4,000)
Taxable Income	$7,200	$6,700
Tax	$723	$673
Saver's Credit	$0	($250)
Tax after Saver's Credit	$723	$423
Net Tax Savings vs. No Retirement Contribution		$300

Example #5: Bill and Leona are age 62. Bill retired in June 2015 and Leona is a homemaker. Bill and Leona file a joint return. In most years, Bill and Leona do not qualify for the saver's credit, however, Bill only worked half the year and their AGI for 2015 is $32,000. On April 1, 2016, Bill makes a 2015 traditional IRA contribution of $2,000. Bill and Leona receive a $943 saver's credit on their 2015 tax return. On May 1, 2016, Bill removes the $2,000 IRA contribution. Bill and Leona receive the $943 saver's credit even though the $2,000 contribution was only in the IRA for one month.

	No Retirement Contribution	$ 2,000 Traditional IRA Contribution
Income	$32,000	$32,000
IRA Deduction	$0	($2,000)
AGI	$32,000	$30,000
Standard Deduction	($12,600)	($12,600)
Personal Exemption	($8,000)	($8,000)
Taxable Income	$11,400	$9,400
Tax	$1,143	$943
Saver's Credit	$0	($943)
Tax after Saver's Credit	$1,143	$0
Net Tax Savings vs. No Retirement Contribution		$1,143

✎ **Author's Comment:** Often, the idea of making a contribution to a traditional IRA is dismissed and a contribution is made to a Roth IRA instead. Taxpayers need to weigh the benefits of making a contribution to a traditional IRA versus the benefits of making a contribution to a Roth IRA. A tax savings in excess of 30% is significant. This is especially true when you consider a taxpayer could possibly take tax-free distributions from an IRA during retirement. See *Tax-Free IRA Withdrawals*, page 11-18.

While the credit is available to all qualifying taxpayers, it is especially worthwhile to consider for someone who has had a significant decrease in income for one year. A taxpayer who consistently has earnings that qualify for the credit often does not have the available cash to invest in an IRA. However, someone who has had a decrease in income for one year might be more likely to have cash available to invest in an IRA.

Possible Risks

- Taxpayers who qualify for the credit often do not have enough money available to fund an IRA contribution. Taxpayers could theoretically use an anticipated tax refund to provide the money for the contribution. This is accomplished by filing a tax return before the tax filing deadline, receiving a refund based partly on the Retirement Savings Contribution Credit, and subsequently funding the IRA contribution before April 15. While this is feasible, if a taxpayer does not fund the IRA contribution, the taxpayer will have filed an incorrect tax return.
- A taxpayer who has taken a distribution from his or her retirement account in the past three tax years may have to reduce the amount of the current contribution when figuring the credit amount.
- Contributions to a traditional IRA include the risk that a future distribution will be subject to a higher tax rate than the current rate by which the deduction is taken. The examples included in this strategy are for illustration purposes only and are meant to be one consideration of a way to enhance the benefits of the saver's

credit and to create the eligibility of the taxpayer to take advantage of the credit.
- As with all retirement accounts, the taxpayer bears the risk of the underlying investment chosen for the retirement account.
- The credit is not available to taxpayers who are students during any five calendar months during the tax year. Often, a student will graduate from college in May, having been a student January through May, and then find employment after graduation. During that particular tax year, the taxpayer may have income to qualify for the saver's credit, but because he or she was a student for five calendar months, he or she does not qualify for the saver's credit.

Life Insurance for Retirement Planning

Cross References

- IRS Pub. 525, *Taxable and Nontaxable Income*
- IRS Pub. 575, *Pension and Annuity Income*
- IRC §72, *Annuities; certain proceeds of endowment and life insurance contracts*
- IRC §101, *Certain death benefits*
- IRC §7702, *Life insurance contract defined*

Tax Issue

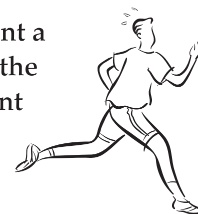
An employee nearing retirement may face a dilemma when it comes to choosing his or her pension. Pension options from a defined benefit retirement plan generally include a lifetime payment with no survivor benefit, a joint and 50% survivor payment, or a joint and 100% survivor payment. The joint and survivor benefits are reduced amounts from the lifetime payment option.

If the employee selects the lifetime payment and then dies before the surviving spouse, no monthly pension will be left for the spouse. If the employee selects one of the survivor options and the spouse dies before the employee dies, the employee will be locked into the lower payout for the rest of his or her life.

The amount of potential loss of income can be devastating to the retired employee or spouse. Emotionally, an employee may be inclined to choose one of the pension options that give an ongoing benefit to his or her surviving spouse. However, this may not be the best financial decision.

Applicable Tax Law

- Death benefits from a life insurance policy are income tax free to the beneficiary.
- Pension income is taxable income to the recipient or beneficiary.
- Immediate annuity payments represent a return of principal and interest. Only the interest portion of the annuity payment is taxable.



Tax Planning Strategies

An employee who is in good health should consider purchasing a life insurance policy that will provide a death benefit to the spouse in the event the employee dies and leaves the spouse without a continuing pension payout. The spouse can then use the death benefit from the insurance policy to create an ongoing income for the rest of his or her life by purchasing an immediate annuity. This income could replace all or some of the amount of income the pension could have provided.

Retired employee's death. If the retired employee dies after choosing the lifetime payout and a life insurance policy, the lifetime payout from the pension will cease. The life insurance will then be paid to the beneficiary income tax free. The spouse could use the death benefit from the life insurance to purchase an immediate annuity that would generate guaranteed lifetime income.

Spouse's death. If the employee's spouse were to die before the retired employee, the retired employee would have several options. First, the lifetime payout would continue on for the retired employee (at the full amount as no survivor benefits were chosen). The life insurance could be continued for other beneficiaries such as children, or the policy could be modified to provide a reduced paid-up insurance amount, or the policy could be terminated completely and any cash value returned to the retired employee.

Tax consequences. The pension amount received by the retired employee or the surviving spouse is taxable at the time of payment. Payout from a life insurance policy is income tax free to the beneficiary. Annuity payouts, from an annuity purchased from the death benefits, will be paid to the spouse as part interest and part return of principal. Depending on the age of the person taking the annuity, the interest rate, and the guaranteed period of time the annuity will pay out, most of the annuity payment will be return of principal. The taxable income from the annuity payments is determined by calculating the exclusion ratio of how much of each payment is return of principal and how much is interest.

If a life insurance policy is changed to a reduced paid-up amount, there are no tax consequences to the retired employee. The death benefit would still be income tax free

when it is paid out to beneficiaries. For a policy that is terminated and cashed in, the amount received greater than the amount of premiums paid into a policy would be taxable income.

Examples

Example: Henry is age 65 and will be retiring soon. He and his wife Louise, also age 65, are reviewing his pension options.

Option	*Monthly Pension*	*Survivor's Monthly Pension*
Life	$2,000	$ 0
50% survivor benefit	$1,600	$ 800
100% survivor benefit	$1,200	$1,200

If Henry chooses the life option and subsequently dies, Louise will be left without any portion of his pension. With the 50% survivor benefit, Henry would receive $400 less per month than the life option, and Louise would receive a pension half of Henry's when he died. With the 100% survivor benefit, Henry would receive $1,200 per month and Louise would receive $1,200 per month upon his death.

Life insurance. Henry is in very good health and a nonsmoker. In reviewing his life insurance options, he discovers he can get a $200,000 universal life insurance policy for $400 per month. If he were to purchase the insurance and die shortly thereafter, Louise could use the $200,000 to purchase a guaranteed annuity payout that would provide her approximately $1,200 per month. Essentially, Henry could take the life pension option, purchase the life insurance policy, and still have a monthly income of $1,600 ($2,000 monthly pension minus $400 insurance premium) left.

Tax consequences. With the 100% survivor benefit, Louise would receive $1,200 of taxable income per month upon Henry's death. With the life option, Louise would receive no pension, but instead would have the life insurance paid to her income tax free. If the proceeds were invested in an immediate annuity paying approximately $1,200 per month, only a portion of the annuity would be taxable income. A smaller income from the annuity purchased from the life insurance proceeds would provide the same after-tax income to the beneficiary. Therefore, a smaller amount of insurance, and subsequently a smaller monthly annuity payment, might be sufficient.

Income Option	*Income Amount*	*Taxable Income*	*Tax Rate*	*Tax*	*Net Income (Income Amount Minus Tax)*
100% survivor benefit	$1,200	$1,200	25%	$300	$900
Immediate annuity	$ 975	$ 300	25%	$ 75	$900

Spouse's death. If Louise were to die before Henry, he would still have his life pension amount of $2,000 per month. He could discontinue or reduce his life insurance and it would free up $400 that he was using to pay the premium. He could also continue paying the monthly premium and leave the policy intact for his children or other beneficiaries. If Henry had chosen the 100% survivor benefit instead of the life option, and Louise was to die before him, his monthly income would continue at $1,200 for the rest of his life.

✎ **Author's Comment:** Just as life insurance is purchased during an employee's working years to protect earned income, life insurance can also be used to protect pension income. If a retiring employee is healthy, life insurance can be an affordable way to insure a pension for the employee's spouse. In the event the spouse dies before the retired employee, the insurance can be kept in force for other beneficiaries, reduced, or discontinued.

Possible Risks

- Life insurance policies generally have an incontestability clause which can allow the insurance company to dispute the death benefits should the insured person die within two years of issue of the policy. The insurance company will investigate the cause of death and compare it with the application for insurance to see if the insured person had knowledge of his or her health condition that could have caused the death. There is a risk of the death benefit not being paid out within the first two years of the policy. These incontestability clauses can differ from state to state.
- Not all defined benefit pension options are as illustrated in the examples. Some pension plans are expanding options to include guaranteed payouts for a certain number of years or a guaranteed specified amount. Employees should research all options before choosing and/or buying life insurance to protect the benefit.
- If the employee is not in good health and a life insurance policy would be expensive, it may not be financially beneficial to purchase an insurance policy.
- In order to keep life insurance premiums minimal, many universal life insurance policies will lapse, or end, at age 100 with no cash value. If an insured person lives to age 100, the insurance will have been 100% cost with no benefit. Universal life insurance policies can offer a guaranteed provision, with more expensive premiums.

- Only an insurance contract can guarantee a death benefit. All examples are for illustration purposes only.
- The entire pension amount is taxable and the life insurance premium is not tax deductible. In the example, previous column, all the $2,000 per month Henry receives in pension income is taxable. The $400 per month insurance

premium is not tax deductible. He therefore has taxable income of $2,000 but only has constructive use of $1,600.
- The health of the spouse must be taken into consideration when selecting the annuity payout. If he or she survives the retired employee, but then dies shortly thereafter, a life annuity payout from the death benefit of the insurance will not provide for return of payment on the annuity. A smaller payout, one that guarantees lifetime income with a certain number of years specified, should be considered for beneficiaries who are not in good health.

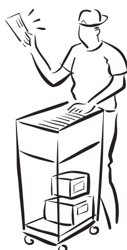
Dispelling 401(k) Loan Myths

Cross References
- IRS Pub. 575, *Pension and Annuity Income*
- IRS Pub. 4222, *401(k) Plans for Small Businesses*
- IRC §401(k), *Cash or deferred arrangements*

Tax Issue
The issue of taking a loan from a 401(k) plan is controversial. Many financial experts warn of the potential pitfalls in taking such loans. While many pitfalls do exist, a 401(k) loan is a viable option for many. For some, it may be the only source of funds, especially in times of emergencies.

Some of the pitfalls that are identified are simply myths. The pitfalls exist because a predetermined perspective on 401(k) loans creates the pitfall. The transaction of taking a 401(k) loan is mechanical in nature, and is not itself controversial.

Applicable Tax Law
- IRC section 401(k) provides taxpayers a way to defer income from wages through an employer-sponsored plan. The employee agrees to reduce his or her salary by a certain amount of money, thereby not paying taxes on the deferred amount. The deferred money is placed into an account that is separate from the employer's assets and allocated into investment accounts.



- Employers often match employees' contributions to the accounts up to a specified limit. The limit can vary from employer to employer and is specified in the employer's plan arrangement.
- The employee pays ordinary income tax when a withdrawal from the account is taken. Unless an exception applies, taxpayers under age 59½ pay an additional 10% penalty on withdrawals from a 401(k) plan.
- The 2015 contribution limits for a 401(k) plan are:
  - Under age 50: $18,000.
  - Age 50 or older: $24,000.
- Most 401(k) plans allow for the employee to take loans against the account balance of the 401(k) plan. Restrictions on the loan amounts can vary from plan to plan.
- Loans taken from a 401(k) plan are not considered taxable distributions.
- Interest paid on a loan from a 401(k) is not tax deductible.

Tax Planning Strategies
Taxpayers seeking a loan may want to consider a loan from a 401(k) plan. While there are risks to this strategy, there are legitimate benefits to it as well. Assuming the 401(k) plan offers the availability of loans, the taxpayer can simply request a loan. Loan amounts are generally limited by the 401(k) plan agreement, the amount available, and if there are any existing loans on the account already. However, if the taxpayer qualifies, a simple request from the taxpayer to the plan administrator can generate a loan. There are no credit checks and funds can be in the taxpayer's hands usually within a week to 10 days from the loan request.

Double-taxation myth. One myth about 401(k) loans is that the repayment is made with after-tax money, and therefore the eventual distribution of the repayments will be double-taxed. It is true that the repayments of the 401(k) loan are made with after-tax dollars. However, it is also true that the distribution of the loan to the taxpayer is not a taxable transaction. The loan principal repayment is therefore a simple replenishment of money to the account the same way that a loan payment on a bank loan is paying down a loan balance.

An argument can be made that loan interest is paid with after-tax earnings and is subject to taxation when a retirement distribution is taken in the future. The loan interest payments are simply growth on the 401(k) account balance, much the same way an account balance would grow, and the subsequent growth be taxed at withdrawal, had the funds remained in the 401(k) and earned the same rate of return as the loan interest.

401(k) loan versus a bank loan. Loan interest paid on a 401(k) loan is paid with after-tax dollars and is not tax deductible. The same is true for a bank loan that does not have any tax advantages. The interest rate charged on either loan is a significant factor in determining the source of the loan. Taxpayers should consider the loan rate offered by a bank loan versus the loan rate offered by the 401(k) plan.

Market-loss myth. Some experts indicate that while a loan is outstanding, the account is not growing as it should. While it is true that the loan fund proceeds are not invested in the funds that are available within the 401(k) during the time the money is loaned out, it is prudent to keep in mind that there are no guarantees on most

of the funds offered in 401(k) plans. Most funds offered in 401(k) plans are mutual funds made up of stocks and bonds. These investment classes can, and do, fluctuate in value. Investment experts are quick to point out that past performance on these investments does not guarantee future results. However, no investment expert can make a guarantee as to the rate of return on stocks and bonds for the future either. Unless future returns can be guaranteed, a future market loss, by not being invested, is a myth.

In contrast, loan repayments are growing at a guaranteed rate—the interest rate charged against the loan. Loan repayments replenish the amount borrowed, plus the additional amounts of interest. The argument against this is that the taxpayer is paying the interest so therefore it is not true growth on the loan amount, but rather an additional, nondeductible, contribution made by the taxpayer. It is true that the interest paid back on a 401(k) loan is not true interest earned that is generated from a source outside of the taxpayer. However, this is an incomplete comparison. The true comparison can be made by analyzing the interest paid to a 401(k) loan versus the interest paid to a third-party, such as a bank loan or credit card. Interest paid on a 401(k) loan is interest that would have otherwise been paid to a third-party.

Time-tested investment advice. A 401(k) loan offers an opportunity for the taxpayer to diversify his or her holdings within the 401(k). When a loan is taken, the funds for the loan are removed from the stock or bond funds and distributed as a loan. While it is true that the loan is a personal liability of the taxpayer, it occurs as an asset on the 401(k) account that is earning a fixed rate of interest as it is repaid. The other benefit provided by a loan is that many 401(k) plans do not offer fixed rate accounts. A loan provides a way for the 401(k) to diversify the types of funds available to invest in.

In addition to providing diversification, repayments of the loan are invested back into the mutual funds within the 401(k) account. These repayments have the effect of dollar-cost-averaging into the funds. While diversification and dollar-cost-averaging do not provide guaranteed results, they are both strong recommendations from financial experts as a way to manage risks.

Examples

Example #1: Double-taxation myth. Alex takes a $10,000 loan from his 401(k). The loan has an interest rate of 5%. Assume the funds in the 401(k) earn 5% over the 2-year repayment of the loan. The interest is compounded monthly for the amounts left in the account and for the contributions as they are made monthly. The interest repaid by the loan is considered earnings in the account, much the same way the account would have earnings had a loan not been taken.

	Option A – No Loan From 401(k)	Option B – $10,000 Loan From 401(k)		
	Investments	*Investments*	*Loan Balance**	*Total*
Beginning balance	$20,000	$10,000	$10,000	$20,000
After year 1	$21,023	$15,921	$5,125	$21,046
After year 2	$22,099	$22,145	$ 0	$22,145

* The loan is considered an asset to the 401(k) plan as it is an obligation owed to the plan.

Note: In this example, the repayments are not double-taxed at all. Had the loan not been taken, the account value would be nearly the same. A distribution would be taxed the same way whether it came from Option A or Option B. This is true if investment results are equal, which illustrates that the true risk of a 401(k) loan is market fluctuations of the funds and not loan interest repayments being double-taxed.

The fact that part of the balance includes interest that Alex paid on the 401(k) loan is irrelevant. The interest paid to the 401(k) loan is simply interest that would have otherwise gone to a bank or other third-party.

Example #2: Market loss myth. Lisa takes a $20,000 loan from her 401(k), with an interest rate of 5%, to buy a car. She leaves the balance of her 401(k) invested in stocks and her loan repayments are allocated to a money market account that is earning 0%. During the repayment period of three years, the stock fund returns 8% the first year, -20% the second year, and -3% the third year.

Note: For illustrative purposes, new contributions to the 401(k) are not shown during the repayment period.

Market returns of 8%, -20% and -3% for years 1, 2, and 3 respectively.

		No 401(k) Loan	$20,000 Loan and $30,000 in Mutual Funds			
	Annual Return on Mutual Fund	*401(k) Account Value*	*Mutual Fund Value*	*Money Market Value*	*Loan Balance*	*Total 401(k) Account Value*
After Year	*Rate of Return*	**$50,000**	$30,000	$ 0	$20,000	**$50,000**
1	8%	**$54,000**	$32,400	$7,193	$13,663	**$53,256**
2	-20%	**$43,200**	$25,920	$14,386	$7,002	**$47,308**
3	-3%	**$41,904**	$25,142	$21,579	$ 0	**$46,721**

The strategy that Lisa used actually produced positive results when compared to not taking the 401(k) loan. This is mainly because the markets went down rather than up. This is not to say that markets cannot or will not go up in value. However, the market-loss-myth lends itself to the false belief that markets always go up, or more specifically, that markets will go up while the loan is outstanding. In that context, if a taxpayer take a 401(k) loan, he or she will lose out on market gains by not having been invested in the markets as the markets were increasing in value.

Market returns of 8%, 0%, and 10% for years 1, 2, and 3 respectively.						
		No 401(k) Loan	**$20,000 Loan and $30,000 in Mutual Funds**			
	Annual Return on Mutual Fund	*401(k) Account Value*	*Mutual Fund Value*	*Money Market Fund Value*	*Loan Value*	*Total 401(k) Account Value*
After Year	*Rate of Return*	**$50,000**	$30,000	$ 0	$20,000	**$50,000**
1	8%	**$54,000**	$32,400	$ 7,193	$13,663	**$53,256**
2	0%	**$54,000**	$32,400	$14,386	$7,002	**$53,788**
3	10%	**$59,400**	$35,640	$21,579	$ 0	**$57,219**

As illustrated, positive returns in the market resulted in a slightly higher mutual fund value versus the loan repayment plan at the end of three years. However, an argument could be made that if Lisa had dollar-cost-averaged her repayments back into the mutual funds rather than putting the money into the money market, her overall account value would be similar to the value created by being fully invested during the three years.

Diversification. This example shows the effect of diversifying 401(k) assets into different categories and how the diversification helps prevent greater fluctuations in the account values. The truth is that no one can predict the direction or velocity of the markets. However, an individual investor does have control over how to diversify his or her investments.

Example #3: A 401(k) loan can create an opportunity for a taxpayer. On March 30, Randy met with his tax preparer and it was determined he could save $1,750 on his federal taxes by making an IRA contribution of $5,000 for the previous year. Randy did not have the cash readily available. He took a $5,000 loan from his 401(k) to fund his IRA contribution. Randy benefits by:

1) Diversifying his assets,
2) Obtaining the immediate tax savings, and
3) Being able to stay in the stock market with the $5,000 if he invests his IRA into the stock market.

Example #4: Steve takes a $10,000 loan from his 401(k) that he uses for a down payment on his house. The loan proceeds, combined with money from savings, makes his down payment exceed 20% of the equity in the home and he subsequently does not have to pay private mortgage insurance.

Author's Comment: While taking a loan of any kind can be risky, a loan taken from a 401(k) plan can have added risks, especially if the taxpayer taking the loan loses his or her job. However, taxpayers can also benefit from a 401(k) loan by having access to readily available funds and by diversifying investments within a 401(k) plan. Often, financial experts object to the 401(k) loan because of a value judgment created about the taxpayer's need to take a loan in the first place. A loan from a 401(k) on its own may not make much sense. However, if the 401(k) loan is compared to another loan, such as a bank loan, there may be some unique advantages. Home equity loans and business loans have distinct tax advantages that a 401(k) loan does not. However, for an ordinary loan, a 401(k) loan should be a consideration versus a bank loan or credit card. This strategy to dispel 401(k) loan myths does not specifically recommend that a 401(k) loan be taken, rather a 401(k) loan be a consideration given a taxpayer's individual situation.

Possible Risks

- As illustrated in the examples, one risk is lost opportunity costs. While the money from a 401(k) is out on loan, it is not invested in the stock or bonds funds of the 401(k). This can generate smaller returns for the investor, especially if the returns of those funds are substantial.
- The biggest risk of a 401(k) loan is loss of employment. If a taxpayer leaves his or her job, outstanding loan balances must be paid back, generally within 60 days. If the loan is not paid back, the outstanding balance of the 401(k) loan is considered a distribution and is taxable. If the taxpayer is under age 59½ or does not qualify for an exception, the 10% early distribution penalty also applies.
- The taxpayer may be eligible for a loan that has tax deductible interest, such as a home equity loan or a business loan. Taxpayers should seek other loan options based on the purpose of the loan.

- These examples cannot fully express the fluctuations in the stock and bond markets for any time period that a loan would be outstanding or during any repayment period. In addition, the market timing of loan repayments cannot be determined as to future market conditions. The examples are meant to demonstrate the outstanding loan is an asset in the 401(k) account with a present value similar to an asset of a mutual fund that has a present value. The fact that the loan is unpaid is not relevant unless or until a life event occurs (such as leaving employment). A personal liability from the taxpayer to the taxpayer's own 401(k) account does not create the 401(k) loan to be a liability for the 401(k).
- Although rare, some 401(k) plans do not allow participants to have an outstanding loan and make current contributions. The taxpayer could miss out on the opportunity to make deductible contributions.
- Taxpayers need to be aware of any additional fees a 401(k) plan might charge for loan processing.
- Taxpayers should make all loan decisions with a specific plan of repayment. This is true regardless of whether it is a bank loan or 401(k) loan.

continued on next page

- Some 401(k) plans do not allow for a taxpayer to have more than one loan outstanding at a time. A loan taken for personal reasons, such as buying a car, may prevent the taxpayer from borrowing money from the 401(k) when needed for an emergency.

Nonqualified Deferred Compensation Plans

Cross References

- IRS Pub. 575, *Pension and Annuity Income*
- IRC §409A, *Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans*
- IRC §457A, *Nonqualified deferred compensation from certain tax indifferent parties*

Tax Issue

A business may want to reward specific executives, highly-compensated employees, employees who meet performance objectives, and attract key employees to remain competitive. Qualified plans in general require employers to meet nondiscrimination rules, which may prevent employers from rewarding certain employees with benefits while excluding others. Qualified plans also have contribution limits, which could reduce the amount an employer may wish to defer on behalf of a key employee.

Applicable Tax Law

A Nonqualified Deferred Compensation (NQDC) plan is any plan or arrangement between an employer and an employee to pay the employee compensation at some future time that does not meet the qualified plan rules.

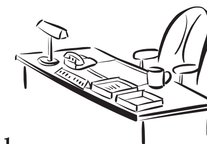
NQDC plans typically fall into four categories.

1) Salary Reduction Arrangements simply defer the receipt of otherwise currently includible compensation by allowing the participant to defer receipt of a portion of his or her salary.
2) Bonus Deferral Plans resemble salary reduction arrangements, except they enable participants to defer receipt of bonuses.
3) Top-Hat Plans (aka Supplemental Executive Retirement Plans or SERPs) are NQDC plans maintained primarily for a select group of management or highly-compensated employees.
4) Excess Benefit Plans are NQDC plans that provide benefits solely to employees whose benefits under the employer's qualified plan are limited by IRC section 415. Despite their name, phantom stock plans are NQDC arrangements, not stock arrangements.

Tax-deferred treatment. In order to receive tax-deferred treatment, a nonqualified plan must either be unfunded, or the employee must be at risk to lose the benefits.

Funded plans. A nonqualified plan is considered a funded plan if an employer sets aside assets, for example, in a trust or escrow account, away from the claims of the employer's creditors to a separate fund for the exclusive benefit of its employees. An employee is taxed on deferred compensation from a funded plan when he or she becomes vested, or when a certain condition (such as meeting a performance goal) happens.

An employee is generally considered vested in the first year in which the employee's rights to the compensation are no longer subject to a substantial risk of forfeiture or his or her rights to the compensation are transferable.



Economic benefit. Under the economic benefit doctrine, if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is currently includible in the individual's gross income. More specifically, the doctrine requires an employee to include in current gross income the value of assets that have been unconditionally and irrevocably transferred as compensation into a fund for the employee's sole benefit, if the employee has a non-forfeitable interest in the fund. The employee will be taxed at the time of receipt of the property if the property is either transferable or not subject to a substantial risk of forfeiture. If the property is not transferable and subject to a substantial risk of forfeiture, no income tax is incurred until it is not subject to a substantial risk of forfeiture or the property becomes transferable.

- ***Substantial risk of forfeiture.*** Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance of substantial services or on the nonperformance of services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services and there is a substantial possibility that the property will be forfeited if the condition does not occur.
- ***Transferable property.*** Property is considered transferable if a person can transfer his or her interest in the property to anyone other than the transferor from whom the property was received. However, property is not considered transferable if the transferee's rights in the property are subject to a substantial risk of forfeiture.

Unfunded plans. An unfunded plan is one where the employee has only the employer's "mere promise to pay" the deferred compensation benefits in the future, and the promise is not secured in any way. The employer may simply keep track of the benefit in a bookkeeping account, or it may voluntarily choose to invest in annuities, securities, or insurance arrangements to help fulfill its promise to pay the employee. Similarly, the employer may transfer amounts to a trust that remains a part of the

employer's general assets, subject to the claims of the employer's creditors if the employer becomes insolvent, in order to help it keep its promise to the employee.

An employee is taxed on deferred compensation from an unfunded plan upon actual or constructive receipt of payment.

- ***Constructive receipt.*** Income is constructively received when an amount is credited to the taxpayer's account or made available to the taxpayer without restriction. The taxpayer does not need to have possession of the income. If someone is authorized to be an agent and receive income for the taxpayer, the taxpayer is considered to have received it when the agent received it. Income is not constructively received if control or its receipt is subject to substantial restrictions or limitations. Holding a check or postponing taking possession of similar property from one tax year to another does not postpone constructive receipt.

Nonqualified deferred compensation does not include any vacation leave, sick leave, compensatory time, disability pay or death benefit plan or any Archer Medical Savings Account, any Health Savings Account, or any other medical reimbursement arrangement that is not includible in income.

An employer generally cannot deduct contributions to a nonqualified plan until they are included in the employee's taxable income.

Tax Planning Strategies

NQDC plans may be formal or informal, and they need not be in writing. While many plans are set forth in extensive detail, some are referenced by nothing more than a few provisions contained in an employment contract.

NQDC plans are often geared toward anticipated retirement in order to provide cash payments to the retiree and to defer taxation to a year when the recipient is in a lower tax bracket.

A NQDC plan examination should focus on when the deferred amounts are includible in the employee's gross income and when those amounts are deductible by the employer. It also should address when deferred amounts must be taken into account for employment tax purposes.

NQDC plans are generally more affordable to implement and maintain than qualified plans. Therefore, these types of plans can be an attractive form of employee compensation for a growing business with limited cash resources.

NQDC plans can be offered on a discriminatory basis and provide unlimited benefits to certain employees, thereby allowing employers to attract and retain key employees.

Examples of nonqualified deferred compensation plans include:

- Variable annuities.
- Life insurance.
- IRC section 457A plans.
- Phantom stock and stock appreciation rights.
- Rabbi trusts.
- Taxable trusts.
- Berger Unfunded Contribution Account (BUCA) plans.

Variable annuities. A contract funded by a lump-sum payment or series of payments that makes periodic payments beginning immediately or at a future date.

Life insurance. An employer may purchase permanent life insurance on the employee's life, with the employer being both owner and beneficiary of the policy. The insurance policy is therefore subject to the claims of the employer's creditors and not currently taxable to the employee. In this arrangement, payment of deferred compensation benefits are not dependent on the employer's cash flow.

IRC section 457A. Compensation deferred under a nonqualified compensation plan of a nonqualified entity is includible in gross income when there is no substantial risk of forfeiture of the right to the compensation. The term nonqualified entity means:

- Any foreign corporation unless substantially all of its income is:
  - Effectively connected with the conduct of a trade or business in the United States, or
  - Subject to a comprehensive foreign income tax, and
- Any partnership unless substantially all of its income is allocated to persons other than:
  - Foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and
  - Tax-exempt organizations.

Phantom stock and stock appreciation rights. Phantom stock and stock appreciation rights are nonqualified deferred compensation arrangements that allow employers to reward employees with stock-based compensation. Phantom stock arrangements involve crediting a specific number of shares to an employee's account without ever issuing the actual shares. At the end of a specified period, the employee receives compensation equal to either the FMV of the shares that were credited or the appreciation in the value of the shares since the date the shares were credited.

Stock appreciation rights provide an employee with the right to receive compensation equal to the increase in the value of a specified number of shares over a specified period of time. For both phantom stock and stock appreciation rights, employees generally recognize taxable compensation when the right to the benefit is exercised.

Stock appreciation rights granted after 2004 have additional restrictions to avoid taxation at the grant date.

1) The exercise price may never be less than the FMV of the stock on the grant date,
2) The stock is traded on an established securities market, and
3) There is no deferral of compensation (other than the deferral of income until exercised).

Rabbi trust. An irrevocable grantor trust set up for the purpose of holding contributions of deferred compensation. The employee is provided with some security that the agreed-to compensation will be paid at the appropriate time and provides assurance that the employer cannot divert the funds for other purposes. However, the terms of the trust must contain a provision that subjects the trust assets to claim by creditors in order to avoid constructive receipt of income by the employee.

Taxable trust. An irrevocable trust set up to receive contributions. The trust assets are protected against claims by creditors. The amounts are considered constructively received, and the employee pays tax on the income at the time the contributions are made. This type of arrangement provides a greater degree of security for the employee but does not defer recognition of taxable income on the deferred compensation.

Exception: Amounts deferred into a taxable trust after December 31, 2004, may qualify for tax deferral if the rules under IRC section 409A are met.

BUCA plan. A BUCA plan (Berger Unfunded Contribution Account) is a binding contract between a key employee and an employer where the employer agrees to contribute a bonus on behalf of an employee into a separate account on the employer's balance sheet. The balance sheet account is earmarked for the employee at a specified future date and is subject to terms and conditions set by the employer where the employee is under substantial risk of forfeiting the account. The contributions plus earnings are not deductible by the employer or taxable to the employee until funds are actually distributed to the employee.

Examples

Example #1: John and his employee, Anne, agree that John will pay Anne a salary of $200,000 a year. In addition, John agrees to pay Anne another $25,000 for each year that Anne works for John, payable upon her retirement. John and Anne have established an unfunded form of nonqualified deferred compensation because it is based merely on John's promise to pay Anne.

Example #2: Assume the same facts as Example #1, except John instead transfers assets to a trust (not subject to claims from his creditors) for the benefit of Anne. In this case, the NQDC plan is considered funded and Anne would be taxed on the amount in the current tax year.

Example #3: Assume the same facts as Example #1, except in a show of good faith, John transfers assets to a rabbi trust ensuring available funds for Anne's future compensation. The terms of the rabbi trust indicate that the assets remain subject to claims by John's creditors, thereby avoiding constructive receipt and being currently taxable to Anne. A rabbi trust is often used for NQDC arrangements because the assets of the trust are considered to be owned by the employer, and the employee has no preferential interest that would provide a current economic benefit.

Example #4: Hyde works at FBO, Inc. His marginal tax rate is 35%. He is given the option of receiving as earned, or deferring until retirement, a $150,000 bonus. Assume Hyde's marginal tax rate at retirement will be 25%. If he decides to receive the $150,000 bonus now, he will be taxed $52,500, but if he defers the income until retirement, he will be taxed only $37,500.

Possible Risks

- There is a general lack of security for employees with unfunded plans as most of these are merely promises to pay certain compensation at a future date with no guarantees.
- NQDC plans are suitable primarily for C corporations. In S corporations, sole proprietorships, and partnerships, business owners generally cannot defer taxes on shares of business income. However, these entities could adopt NQDC plans for an employee who does not have ownership in the business.
- If the employee has control over receipt of deferred amounts without substantial limits or restrictions, the amounts are taxable under the constructive receipt doctrine.
- If a NQDC plan is funded, the employee generally pays current income tax on amounts contributed to the plan. This scenario may not be beneficial from the employee's standpoint because the employee must pay tax now, but might not be able to access the funds until some point in the future. Additionally, the employer enjoys no tax advantage because the employer gets the same tax deduction whether amounts are contributed to the NQDC plan or paid directly to the employee as compensation.
- If, at any time during the tax year, the nonqualified deferred compensation plan fails to meet certain requirements, or is not operated under the requirements, all amounts deferred under the plan for the tax year and all preceding tax years are included in a taxpayer's income

for the current year and the taxpayer may be subject to an additional 20% penalty tax.

- To obtain the benefit of income tax deferral, it is important that the amounts are not set aside from the employer's creditors for the exclusive benefit of the employee. If amounts are set aside from the employer's creditors for the exclusive benefit of the employee, the employee may have currently includible compensation.
- A rabbi trust protects employees against the employer's second thoughts regarding future compensation, but does not protect against a change in the employer's financial condition leading to bankruptcy.
- Interest or earnings credited to amounts deferred under NQDC plans do not qualify as interest deductible by an employer. Rather, the employer must pay income tax on any earnings attributable to allocated funds set aside for paying future benefits.
- Employers must understand when NQDC plans are taxable to their employees because the employer is required to withhold income taxes from NQDC amounts at the time the amounts are actually or constructively received by the employee.

Court Cases

Court Case: The IRS determined a deficiency of $3,910,000 in the 2001 federal income tax of Kenneth L. Lay (CEO of Enron) and Linda P. Lay (the Lays). The deficiency was based upon the IRS' determination that the Lays received income as a result of the sale of two annuity contracts to Enron. Mr. Lay initially retired from Enron and then was later pursued to return when his successor suddenly quit. As a long-term incentive award if he remained with Enron for a 4.25 year term (or left the employment of Enron for certain reasons outside his control), the Lays sold their annuity contracts for $5 million each, $10 million total, and Mr. Lay accepted an offer to earn back the annuity contracts for his service to the company. Enron transferred $10 million to the bank account of the Lays by wire transfer in exchange for the transfer of the two annuity contracts. The Lays reported the sale of the annuities on their 2001 tax return with zero gain or loss on the sale due to their basis being $5 million for each contract. Enron issued a Form W-2 to Mr. Lay for 2001 to report compensation paid to him and did not include any part of the $10 million that Enron paid for the annuity contracts.

In 2004, pursuant to an agreement with the IRS, Enron issued an amended Form W-2 to Mr. Lay for 2001 reporting the $10 million as compensation. The IRS then determined a deficiency for the Lays' 2001 tax return based on the amended Form W-2. After reviewing the agreement between Mr. Lay and Enron, the Tax Court determined that the provision of the agreement, allowing Mr. Lay to earn back the annuity contracts, created an unfunded and unsecured promise to transfer property in the future. The arrangement was therefore a nonqualified deferred compensation plan not taxed in 2001 because the annuity contracts were not set aside nor protected from the creditors of Enron. The Lays did not constructively receive any income and did not have control over the annuity contracts, and Mr. Lay's right to the annuities was subject to a substantial risk of forfeiture. Therefore, the court found that the Lays did not receive the income determined by the IRS and were not liable for the deficiency assessed. *(Lay,* T.C. Memo 2011-208)

Court Case: Mr. Bell incorporated Bell Capital Management (BCM) in 1984 and elected to treat BCM as an S corporation in 1988. Mr. Bell owned 100% of BCM and was its sole director. During 1991 through 2001, Mr. Bell's duties as BCM's employee included the supervision and direction of business operations, providing services to clients as a financial planner, investment counselor, and wealth manager. From 1991 through 1995, BCM paid Mr. Bell wages of $761,978, $978,772, $691,006, $589,760, and $630,760, respectively. During 1996 through 2001, the taxable years in issue, Mr. Bell reported on his federal income tax returns wages of $75,000, $75,000, $75,000, $75,000, $75,000, and $37,500, respectively. For 1996 through 2000, Mr. Bell reported on his federal income tax returns wages received from Nationwide Executive Staff Leasing (NESL), and for 2001 Mr. Bell reported on his federal income tax return wages received from International Leasing Services (ILS). Mr. Bell, on behalf of himself and his corporation, entered into a number of agreements which attempted to make him a leased employee, at a much lower salary, with his remaining salary deferred until age 75. The arrangements enabled Mr. Bell to retain control over a large majority of his deferred salary and he used the funds to make various investments, loans to his church, and purchased a family home. The Tax Court determined that Mr. Bell was engaged in fraud and that he had constructively received the deferred amounts because he has access to and control over the money. *(Foxworthy, Inc.,* T.C. Memo 2009-203)

Invest IRA Money in Real Estate

Cross References

- IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*
- IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
- IRC §408, *Individual retirement accounts*
- IRC §408A, *Roth IRAs*
- IRC §4975, *Tax on prohibited transactions*
- Reg. §1.408-2, *Individual retirement accounts*

Tax Issue

Most taxpayers hold securities, bonds, CDs, mutual funds, exchange traded funds, or similar investment vehicles in a traditional IRAs or Roth IRAs. These investments may decrease in value or fluctuate unpredictably with the stock market, yet many banks or brokers do not offer alternative IRA investments. However, an IRA may

invest in almost any type of asset except for insurance contracts and most collectibles. Rather than using a bank or broker as trustee, the taxpayer can establish a self-directed IRA. The use of a self-directed IRA to invest in real estate can generate significant income for the IRA while the underlying asset increases in value.

Applicable Tax Law

- An individual retirement account, or IRA, is a trust created or organized in the United States for the exclusive benefit of an individual. The governing instrument creating the trust must be written and must meet certain statutory requirements as described in IRC section 408(a). Among those requirements are the following:
  - The IRA must have a trustee who is someone other than the IRAs beneficiary. The trustee must be a bank or other person who has been approved by the Commissioner of Revenue, as described in Regulation section 1.408-2(e).
  - The assets of the IRA must not be commingled with other property except in a common trust fund or common investment fund.

- Roth IRAs are treated like traditional IRAs except:
  - Contributions to a Roth IRA are not tax deductible, and distributions are tax free if specific requirements are met.
  - Taxpayers who have compensation may contribute to a Roth IRA after age 70½.
  - Minimum distributions are not required during the taxpayer's lifetime.
- Both traditional and Roth IRAs are subject to the prohibited transaction rules described in IRC section 4975. A prohibited transaction is any improper use of IRA funds by a disqualified person, including the beneficiary, spouse, ancestors or lineal descendents of the beneficiary, and entities (other than the IRA and its assets) in which the beneficiary directly or indirectly holds a controlling equity or management interest. When a prohibited transaction occurs, the fair market value of the entire IRA is treated as being distributed to the owner on the first day of the tax year in which the transaction occurs. Early withdrawal penalties and prohibited transaction penalties may also apply. Examples of prohibited transactions include any of the following direct or indirect actions with respect to the traditional or Roth IRA by a disqualified person.
  - Borrowing money from the IRA or using the IRA as security for a loan.
  - Selling, exchanging, or leasing of property between the IRA and a disqualified person.
  - Transferring to, or using, IRA assets by, or for the benefit of, a disqualified person.

  - Furnishing goods, services, or facilities between an IRA and disqualified person.
  - Receiving unreasonable compensation for managing the IRA.
  - Buying property for personal use (present or future) with IRA funds.

Tax Planning Strategies

Use of a self-directed IRA allows the taxpayer to invest in real estate, which has the potential for significant appreciation. Although taxes, interest, depreciation, and other operating expenses are not tax deductible within an IRA, an income property can immediately produce revenue and provide a positive cash flow for the IRA. When IRA-held real estate is sold, the usual concerns with depreciation recapture, Form 4797, reinvestment, and the like are not an issue. If the self-directed IRA is a Roth IRA, IRA-held real estate can be distributed to the beneficiary tax free when holding period requirements are met. Setting up a self-directed IRA to invest in real estate can be done in the following way.

1) **Find a custodian.** The taxpayer identifies an independent administrator to serve as custodian or trustee for the self-directed traditional or Roth IRA. There are many companies that specialize in this area and it is important to choose a custodian that meets IRS regulations.

2) **Open a new IRA.** The new self-directed IRA can be a traditional or Roth IRA, established with the self-directed IRA custodian.
3) **Fund the IRA.** The taxpayer funds the account with new money up to the amount of the current IRA contribution limits or transfers retirement funds from another account to the new IRA (or both). If the new account is a Roth IRA, it could be funded with a Roth conversion. If not using a trustee-to-trustee transfer, it is crucial that the rollovers be completed within the 60-day statutory time frame.
4) **Establish an LLC and specify the LLC manager.** Establish a new single-member LLC in compliance with state law. The company providing custodial services will generally guide the taxpayer through this process and structure the LLC properly. The IRA beneficiary is usually designated as the LLC manager, but the manager can be anyone else.
5) **Fund the LLC.** The custodian invests the IRA funds in the LLC by making a deposit into the LLC's bank account. The IRA is now the owner and sole member of the LLC. Some of the IRA money is reserved to pay custodial fees, etc.
6) **Invest LLC funds.** The IRA beneficiary, acting as manager of the LLC, invests the LLC funds as he or she desires. This kind of authority by the beneficiary is known as "checkbook control." The LLC retains suffi-

cient funds to cover expenses, such as insurance, taxes, and other carrying costs. Assets purchased with LLC funds must be titled in the name of the LLC, not in the name of the self-directed IRA.

7) **Avoid prohibited transactions.** Engaging in a prohibited transaction, also known as "self-dealing," may cause the entire IRA to be voided and the deemed distribution of all the assets at fair market value. IRC section 4975(f)(11)(A) provides for correction of prohibited transactions in some circumstances, if the correction is made within 14 days of discovery.
8) **Comply with reporting requirements.** The custodian must report year-end IRA account values to the IRS on Form 5498. Generally, this means that the self-directed IRA beneficiary must have an appraisal or other reliable annual evaluation of the value of the IRA investment. If an LLC is used to hold property, some custodians also require annual financial statements reporting the activity of the LLC. Even if such financial statements are not required by the custodian, careful accounting of the LLC's income and expenses should be made. Note that the single-member LLC is a disregarded entity and does not file its own tax return.

✎ **Author's Comment:** Although the use of an LLC is not required, an LLC gives the manager-beneficiary the greatest amount of control over the IRA investments. If an LLC is not used, the beneficiary must direct the custodian (or trustee used by the custodian) to purchase assets with IRA funds and title them in the name of the IRA. The custodian or trustee then generally handles the day-to-day expenses and income of the IRA assets. This type of arrangement can be impractical and expensive. Even worse, prohibited transactions may occur if the beneficiary takes on any management functions with respect to IRA assets.

Examples

Example #1: Jason decided to invest in the real estate market and identified two bank-owned houses that were in good condition and could be purchased at bargain prices. Before entering into purchase contracts, he did extensive research on self-directed IRAs and attended seminars offered by several different custodian companies. He selected Custodian, Inc. to be the custodian of his new self-directed IRA. An IRA was established with the name "*IRA fbo Jason*," with Custodian, Inc. as the IRA custodian. Jason rolled $265,000 from a 401(k) plan into the IRA. Custodian, Inc. helped Jason set up a new LLC ("Holdings LLC") in compliance with the laws of Jason's state, with the *IRA fbo Jason* as the sole LLC member and Jason as the LLC manager. Jason directed the IRA custodian to fund the LLC by transferring $250,000 into the Holdings LLC bank account. Cash left in the *IRA fbo Jason* pays Custodian, Inc.'s annual fees. Jason, acting as manager for Holdings LLC, then made offers to the bank for both houses, acquiring each for $80,000. The owner of each house was Holdings LLC. Holdings LLC contracted with a rental management company to find tenants and manage the properties.

Within a few months, both properties are showing a positive cash flow. Rent checks are deposited into the LLC bank account. Holdings LLC has plenty of cash on hand to cover repairs, maintenance, insurance, taxes, etc., and manager Jason decides that Holdings LLC is ready to purchase a third property—a vacant parcel of land. Holdings LLC contracts with a debris removal company to clear the property of rubbish and prepare it as a building site. The land is then sold to a developer at a profit, which is deposited into the LLC bank account. Jason, acting as manager of Holdings LLC, keeps careful records of LLC expenses and he hires an accountant to produce periodic financial statements. As LLC manager, Jason has each of Holdings LLC's properties appraised at the end of each year and submits the appraisals to Custodian, Inc. together with the year-end financial statements. Custodian, Inc. uses this information and the IRA cash amount remaining to prepare Form 5498, *IRA Contribution Information,* as well as other required paperwork.

Example #2: Assume the same facts as Example #1, except now several years have passed and the cash left in the IRA is insufficient to pay the annual fee charged by Custodian, Inc. Jason considers paying the fees with personal funds, but knows that Schedule A limitations mean he will receive no tax benefit for that expense. He is eligible to make IRA contributions, so he makes his current-year contribution to the *IRA fbo Jason*. Now the custodian fees can be paid with the new IRA contribution.

Example #3: Assume the same as Example #1, except Jason turned age 70½ in the current tax year. *IRA fbo Jason* is a traditional IRA and Jason is subject to the minimum distribution requirements. Thanks to Jason's careful work as manager of Holdings LLC and increasing property values, Custodian, Inc. reports that the *IRA fbo Jason* has a year-end value of $548,000. Unless Jason has other liquid IRA accounts, he will be required to take a distribution for the current year of approximately $20,000 from the *IRA fbo Jason*, based on his own life expectancy. (If Jason is married and his wife is more than 10 years younger than he is, he can use the Joint Life and Last Survivor Expectancy Table to calculate a lower distribution amount.) Jason has several options for taking these required minimum distributions from the *IRA fbo Jason*. For example:

- He can direct Custodian, Inc. to bill him directly for the annual fees so that distributable cash can accumulate in the IRA.
- An LLC can make distributions only to its member(s) so Jason cannot receive cash or property directly from Holdings LLC in satisfaction of the minimum distribution requirements. But as Holdings LLC manager, he can have the LLC make cash or property distributions to the *IRA fbo Jason*, which

can in turn distribute the cash or property (at fair market value) to Jason as an RMD.
- *IRA fbo Jason* can distribute a percentage of Holdings LLC to Jason to satisfy his RMD requirements. When this happens, Holdings LLC is no longer a disregarded entity and must file an annual tax return, including K-1s for Jason and for *IRA fbo Jason*.

Example #4: Assume the same facts as Example #1, except the *IRA fbo Jason* is a Roth IRA. Jason is not required to take minimum distributions during his lifetime, and distributions he does take are not taxable if he meets the requirements. Jason is over age 59½ and decides to take a distribution of one of the rental houses. If he has previously met the five-year holding requirement for any Roth IRA, the house passes to him tax free and penalty free. The house could become Jason's retirement home, a vacation home, a rental activity run outside his IRA, etc. If Jason sells the house, his basis is the fair market value of the house when it was distributed (true whether the IRA is a Roth or a traditional IRA). The fair market value of the distribution is reported to Jason on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

Example #5: Assume the same facts as Example #1, except Jason's son owns a home he can't afford. Jason sees an opportunity to help his son. As manager, he directs Holdings LLC to purchase the home and rent it back to his son.

He consults neither Custodian, Inc. nor his tax preparer before taking this action, but the arrangement looks like it will work well and his son is happy. He submits year-end property appraisals to Custodian, Inc., which prepares Form 5498, *IRA Contribution Information,* without questioning the nature of the new acquisition. Jason's alert tax preparer uncovers the problem when she asks to see the closing papers in connection with preparing Holdings LLC's financial statements. Jason has engaged in not one, but two prohibited transactions: purchasing property for the IRA from a disqualified person and renting IRA property to a disqualified person. The entire fair market value of Jason's self-directed IRA is considered to have been distributed to Jason as of the first day of the year in which Holdings LLC purchased the son's home, and the IRA ceases to be an IRA. Jason has no choice but to sell off his assets to pay the taxes and penalties resulting from his desire to help his son using his self-directed IRA. Jason would have been much better off to buy the son's home outside his IRA and rent it back to him at fair market value.

Example #6: Assume the same facts as Example #1, except one of the rental houses owned by Holdings LLC needs immediate repairs that are not covered by insurance. A tenant has trashed the place, moved out, and the property needs work before it can be rented again. There is not enough money in either the Holdings LLC account or the *IRA fbo Jason* cash reserves to cover the costs, and Holdings LLC cannot get a short-term loan. Jason considers lending money to his self-directed IRA, thinking he will be repaid when the rent payments begin again. Jason consults his tax preparer this time, who points out that such a loan would be a prohibited transaction. Instead, she advises Jason to make the maximum IRA contribution to the *IRA fbo Jason*. It's only February, so Jason makes a contribution both for the prior tax year and for the current tax year, even though he knows excess contributions may be the result. The repairs are made and rent starts flowing again. Jason can withdraw any excess contribution and earnings penalty-free prior to the usual 1040 due date, plus extensions. If it turns out that there is no cash available yet to make this withdrawal, Jason can delay the correction and pay a 6% excise tax per year on the excess contribution amount.

Example #7: Marla's self-directed IRA owns a posh condo in Park City, Utah, and the IRA rents the condo to skiers and other vacationers for $250–$500 per night, depending on the season. When Marla goes to Park City to ski each December, she never stays in the condo, but she really wishes she could do so just once. She tells the management company not to rent it out for the month of December 2015, and she directs the custodian company to distribute the condo to her. The custodian company complies and makes sure the condo is deeded to Marla, the change in ownership is legally recorded, and all required fees paid. Marla enjoys the condo and skis to her heart's content all month. Then in January 2015, she deeds the condo back to another self-directed IRA well before the 60-day rollover period expires. She is very careful to document that she is rolling back exactly the same property and has the deed and change in ownership legally recorded. Marla receives a Form 1099-R, for the full market value of the distributed condo. She reports the value on line 16a of her 2015 Form 1040, zero on line 16b, and enters "Rollover" next to line 16b. The second self-directed IRA will report the receipt of a rollover contribution on Form 5498, *IRA Contribution Information,* for 2016. Marla realizes that the costs of pulling off this rollover are about what she would have paid to stay in a similar condo, but at least she has the satisfaction of experiencing the condo owned by her IRA for that one month.

Possible Risks

- Self-directed real estate IRAs are trendy investments and there are numerous companies promoting them and offering custodial services. Custodian firms do not necessarily review or supervise the self-directed investments, and not all such custodian firms are reliable or trustworthy. Custodian firms have been accused in lawsuits of predatory practices, improper use of investor funds, conspiracy, fraud, negligence, elder abuse, and other charges. Some of the Madoff ponzi scheme victims lost their investments in self-directed IRAs. Taxpayers should thoroughly investigate each custodian firm being considered.
- The most common risk associated with a self-directed real estate IRA is the inadvertent prohibited transaction. When a prohibited transaction occurs, the fair market value of the entire IRA is treated as being distributed to the owner on the first day of the tax year in which the transaction occurs and the IRA ceases to be an IRA. Resulting taxes and penalties can spell financial disaster for the IRA owner. The following are a few examples of prohibited transactions that can occur when real estate is held in a self-directed IRA.
  - Using IRA-owned property for personal use, including use as a vacation home or other temporary personal use.
  - Allowing any disqualified person to live in IRA-owned property. Even a bona fide rental to an otherwise non-disqualified person, such as a brother, might meet with IRS disapproval. For example, a relative could be viewed as having influence on decisions made by the IRA beneficiary.
  - Personally receiving rental income from IRA-owned property, such as deposit of rent checks into a personal account. Rent should be deposited directly into the IRA or into the LLC checking account if an LLC is being used to hold the rental property.
  - Paying IRA expenses with personal funds, such as writing a personal check when the IRA is short of cash. The self-directed IRA should keep enough cash on hand to cover all foreseeable expenses. A beneficiary who lends money to the IRA may disqualify the entire IRA.
  - Use of IRA funds for non-IRA purposes, with the intention of reimbursing the IRA checking account later.

  - Providing goods or services to IRA-owned property by any disqualified person, such as mowing the lawn or making repairs. Taxpayers who hold rental real estate in self-directed IRAs should consider using property managers, taking care not to hire a disqualified person.
  - Depositing new IRA contributions into the LLC checking account instead of into the IRA. It's important to make the distinction between the IRA and assets owned by the IRA. A deposit into the LLC checking account could be deemed a loan or a purchase of IRA assets by the beneficiary.

  One way to help demonstrate that prohibited transactions have not occurred is to keep a detailed accounting of all LLC activity, just as if the LLC were filing a tax return.
- Funding the self-directed IRA is subject to the same risks as other IRAs. For example, a rollover may be delayed, the taxpayer may be unprepared for income taxes associated with a Roth conversion, or the amount of cash available may be insufficient to make the investment the taxpayer has in mind.
- If sufficient IRA funds are not available to buy a property outright, the IRA may need to obtain a mortgage or other loan. Such a loan would have to be non-recourse, since the IRA owner cannot personally guarantee the loan and the IRA itself cannot be pledged as security. Many lenders are unwilling to write a loan under these circumstances. In addition, profits attributable to debt may be classified as unrelated debt financed income, subject to tax at trust rates. This tax is discussed in IRC section 514.
- An IRA that operates a business may be subject to the unrelated business taxable income (UBTI) rules. For example, a self-directed IRA may own equipment used in maintaining its rental properties. Renting out the equipment for the use of others may create UBTI, requiring the IRA to report the income and pay tax on Form 990-T, *Exempt Organization Business Income Tax Return.* This tax is discussed in IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations.*
- Some taxpayers mistakenly transfer real estate or other assets they own outside an IRA into a self-directed IRA, perhaps in an effort to fund the self-directed IRA, furnish a rental property owned by the self-directed IRA, repay a distribution, etc. Selling or transferring personally-owned property to an IRA is not permitted.
- Real estate tax advantages, such as deductions for depreciation and interest, are lost when real estate is held in an IRA. The investor who is accustomed to these deductions will be disappointed.
- Not all real estate increases in value, and not all renters are trouble free. Real estate investments can be just as much of a money loser in a self-directed IRA as they might be otherwise.
- Failure to plan for required distributions before and after the beneficiary's death can create problems. If the self-directed IRA is not a Roth IRA, minimum distributions will eventually be required. This may necessitate liquidation of the investment if other IRA accounts cannot be used to arrive at the required amount. It may be possible to distribute membership interest in the LLC to satisfy the RMD rules. In this case, the LLC would no longer be a disregarded entity and must file an annual tax return. Both traditional and Roth self-directed IRAs can be inherited, but distributions will be required after

the beneficiary's death. The beneficiary may wish to include distribution instructions in his or her will or trust documents.

Court Cases

Court Case: Companies who offer custodial services for self-directed IRAs often cite *Swanson* as the authority for using an LLC structure to invest IRA funds. Mr. Swanson formed a self-directed IRA and, at the same time, created a corporation named Worldwide. His IRA purchased 100% of the outstanding shares of Worldwide. He was then appointed president of Worldwide and had complete control of the corporation. Worldwide made a lot of money doing business with another company owned by Mr. Swanson. The IRS contended that the purchase of Worldwide shares by the IRA, the appointment of Mr. Swanson as Worldwide president, and the payment of dividends back to the IRA by Worldwide were all prohibited transactions. The Tax Court disagreed with the IRS and decided that none of these actions were prohibited transactions. The IRS was required to pay Mr. Swanson's reasonable court costs and attorney fees. *(Swanson,* 106 T.C. No. 3)

Court Case: It is crucial that statutory requirements are met when setting up a self-directed IRA. Mr. Kirschenbaum became dissatisfied with the 8% return on the investments in his IRA brokerage account and decided that he could do better as a real estate investor. A distribution from his IRA of almost $50,000 was deposited directly to the account of Marlene Hope, Inc. (MHI), a company engaged in the business of real estate purchasing, selling and development, residential real estate management, and real estate mortgaging. MHI used Mr. Kirschenbaum's IRA distribution to purchase a single family residence. The house was rented out for $800 a month, and the tenant reimbursed MHI directly for utility expenses. MHI held the title to the house and retained the money received from the tenant. Mr. Kirschenbaum treated the investment in the rental property as his IRA, and MHI's corporate records referred to it as his IRA. This seemed sufficient to Mr. Kirschenbaum because Marlene Hope was his daughter and he trusted her to manage what he thought was his IRA.

The IRS decided that the arrangement was not an IRA. The Tax Court agreed because there was no written governing instrument that met IRA statutory requirements. Mr. Kirschenbaum's arrangement with MHI did not constitute an IRA and the entire distribution was taxable.

The resulting increase in adjusted gross income for the year in question increased the taxable amount of Mr. Kirschenbaum's Social Security benefits and limited the amount of his wife's IRA deduction. In addition, Mr. Kirschenbaum was deemed as having made a gift of the distribution amount to his daughter. Unaddressed by the court were the rent and utility payments (which presumably were income to MHI), negligence on the part of MHI, and gift tax consequences. *(Kirschenbaum,* T.C. Summary 2002-152)

Court Case: Good intentions, partial compliance, and the internet are no substitute for following the rules in using a self-directed IRA. Mr. Woodard established a self-directed IRA which he intended to invest in private mortgages, but he failed to complete a rollover of his distribution within the 60-day statutory period. He conceded that he had not met the rollover requirements but insisted that he should not be liable for IRS-imposed accuracy-related penalties. He had searched the internet and maintained that he was following instructions that he found online and that he always intended that the failed rollover remain a self-directed IRA. Because Mr. Woodard did not provide website information or other sources for the internet advice, the Tax Court was unable to consider that he had acted in good faith or exercised ordinary business care and prudence in relying on this information. Not only was his entire distribution taxable, but accuracy-related penalties were allowed to stand. *(Woodard,* T.C. Summary 2009-150)

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