Section 2: Income and Assets

2.2 Retirement Income

1. Basis in a Traditional IRA (Form 8606)

If the traditional IRA was deductible, then the basis for the IRA is zero and the entire amount of the rollover or conversion is included in gross income. If nondeductible, then the basis for the IRA is equal to the sum of the contributions. Thus, only the IRA earnings included in the rollover or conversion are included in gross income.

2. Comparison of and Distributions form Traditional and Roth IRAs

There are two major Retirement IRAs

- Conventional
- Roth

Roth IRAs

Contributions are not deductible

Earnings distributions are tax-free if:

- The IRA has existed for 5 years, and
- The Taxpayer is >59 1/2 years old
- There is no age limit to begin distributions

Contributions are phased-out in the same manner as for a:

Traditional IRAs

Conventional IRAs have different AGI limits:

- Married beginning at $193,000
- Others beginning at $123,000

Individual Retirement Accounts

Individual retirement accounts contributions:

For 2019 you will be able to save up to $19,000 in your 401(k) up from $18,000 in 2018

- All taxpayers may contribute a maximum of $6,000 of their earned income to a Deductible or a Roth IRA; Up from $5,500 in 2018
- Special “Catch-up” rule allows up to $6,500 if 50 or older.
- A married couple may contribute $12,000 ($6,000 per person in total; $ 7,000 per person for those 50 and older).

Conventional IRA

Contributions limited to lesser of $ 6,000 ($ 7,000 if ≥ 50) or amount of earned income

- Fully deductible if not covered by an employer's plan
- Not linked to spouse's coverage

If covered, maximum deduction equals: (Maximum contribution) x [1 – IRA percentage*]* (AGI - phase-out) / $10,000 ($20,000 MFJ)

Phase out amounts:

- The modified AGI for singles must be under $137,000 with phase out starting at $127,000
- The modified AGI for MFJ must be under $203.000 with phase out starting at $193,000

Conventional IRA Example

For 2018:

Single taxpayer with AGI = $62,000 contributes $5,500 to an IRA. How much is deductible if the taxpayer is covered by a qualified plan?

- $5,500 X [1 - ($62,000 - $61,000)/10,000]
- = $5,500 X [1 - 0.10]
- = $5,500 X 0.90
- = $4,950 maximum deduction

3. Distributions from qualified and non-qualified plans (e.g., pre-tax, after-tax, rollovers, 1099R

A taxpayer who receives a distribution can avoid current taxation by rolling the distribution into another qualified employer retirement plan or into an IRA. The taxation is deferred until distributions are made from the recipient's qualified employer retirement plan or IRA. The rollover can be direct with the balance in the account going directly into another qualified plan or IRA. The rollover can be indirect (subject to a 20 percent withholding) where the employee has 60 days to transfer the proceeds into another qualifies plan or IRA.

IRA Rollover per year limit

Amounts from traditional IRAs may be rolled over tax-free only once in a 12-month period. If a person has more than one IRA, the one-year waiting period applies separately to each IRA. Rollovers are not available for required distributions under the minimum distribution rules once age 70.5 is reached.

4. Excess Contributions and Tax Treatment (Penalties)

If contributions to your IRA for a year were more than the limit, you can apply the excess contribution in one year to a later year if the contributions for that later year are less than the maximum allowed for that year. However, a penalty or additional tax may apply. Generally, an excess contribution is the amount contributed to your traditional IRAs for the year that is more than the smaller of:

$6,000 ($ 7,000 if you are age 50 or older), or your taxable compensation for the year. The taxable compensation limit applies whether your contributions are deductible or nondeductible. Contributions for the year you reach age 70½ and any later year are also excess contributions. An excess contribution could be the result of your contribution, your spouse's contribution, your employer's contribution, or an improper rollover contribution.

Tax on Excess Contributions

In general, if the excess contributions for a year are not withdrawn by the date your return for the year is due (including extensions), you are subject to a 6% tax. You must pay the 6% tax each year on excess amounts that remain in your traditional IRA at the end of your tax year. The tax cannot be more than 6% of the combined value of all your IRAs as of the end of your tax year.

Excess Contributions Withdrawn by Due Date of Return

You will not have to pay the 6% tax if you withdraw an excess contribution made during a tax year and you also withdraw any interest or other income earned on the excess contribution. You must complete your withdrawal by the date your tax return for that year is due, including extensions. W**ithdrawn contributions are** not include in your gross income an excess contribution that you withdraw from your traditional IRA before your tax return is due if both of the following conditions are met.

Excess Contributions Withdrawn by Due Date of Return

No deduction is allowed for the excess contribution. The withdrawal includes the interest or other income earned on the excess contribution. **You can** take into account any loss on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income withdrawn may be a negative amount.

In most cases, the net income transferred will be determined by an IRA trustee or custodian.

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5. Prohibited Transactions and Tax Effects

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

Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

Prohibited Transactions and Tax Effects

The following are some examples of prohibited transactions with a traditional IRA

- Borrowing money from it.
- Selling property to it.
- Using it as security for a loan.

Buying property for personal use (present or future) with IRA funds.If your IRA invested in nonpublicly traded assets or assets that you directly control, the risk of engaging in a prohibited transaction in connection with your IRA may be increased.

Fiduciary. For these purposes, a fiduciary includes anyone who does any of the following. Exercises any discretionary authority or discretionary control in managing your IRA or exercises any authority or control in managing or disposing of its assets. Provides investment advice to your IRA for a fee, or has any authority or responsibility to do so. Has any discretionary authority or discretionary responsibility in administering your IRA.

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

Effect on you or your beneficiary. If your account stops being an IRA because you or your beneficiary engaged in a prohibited transaction, the account is treated as distributing all its assets to you at their fair market values on the first day of the year. If the total of those values is more than your basis in the IRA, you will have a taxable gain that is includible in your income. For information on figuring your gain and reporting it in income, see *Are Distributions Taxable*, earlier. The distribution may be subject to additional taxes or penalties.

Borrowing on an annuity contract. If you borrow money against your traditional IRA annuity contract, you must include in your gross income the fair market value of the annuity contract as of the first day of your tax year. You may have to pay the 10% additional tax on early distributions, discussed later.

Pledging an account as security. If you use a part of your traditional IRA account as security for a loan, that part is treated as a distribution and is included in your gross income. You may have to pay the 10% additional tax on early distributions, discussed later.

Trust account set up by an employer or an employee association. Your account or annuity does not lose its IRA treatment if your employer or the employee association with whom you have your traditional IRA engages in a prohibited transaction.

Owner participation. If you participate in the prohibited transaction with your employer or the association, your account is no longer treated as an IRA.

6. IRA conversions and recharacterizations (Form 8606)

Allowable conversions. You can withdraw all or part of the assets from a traditional IRA and reinvest them (within 60 days) in a Roth IRA. The amount that you withdraw and timely contribute (convert) to the Roth IRA is called a conversion contribution. If properly (and timely) rolled over, the 10% additional tax on early distributions will not apply. However, a part or all of the distribution from your traditional IRA may be included in gross income and subjected to ordinary income tax.

IRA conversions and recharacterizations (Form 8606

- You must roll over into the Roth IRA the same property you received from the traditional IRA. You can roll over part of the withdrawal into a Roth IRA and keep the rest of it. The amount you keep will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on early distributions. See *When Can You Withdraw or Use Assets*, later, for more information on distributions from traditional IRAs and *Early Distributions* in Publication 590-B for more information on the tax on early distributions.

Periodic distributions. If you started taking substantially equal periodic payments from a traditional IRA, you can convert the amounts in the traditional IRA to a Roth IRA and then continue the periodic payments. The 10% additional tax on early distributions will not apply even if the distributions are not qualified distributions (as long as they are part of a series of substantially equal periodic payments).

Required distributions. You cannot convert amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you reach age 70½) under the required distribution rules (discussed in Publication 590-B).

Income. You must include in your gross income distributions from a traditional IRA that you would have had to include in income if you had not converted them into a Roth IRA. These amounts are normally included in income on your return for the year that you converted them from a traditional IRA to a Roth IRA.

You do not include in gross income any part of a distribution from a traditional IRA that is a return of your basis, as discussed under *Are Distributions Taxable* in Publication 590-B. If you must include any amount in your gross income, you may have to increase your withholding or make estimated tax payments. See Publication 505, Tax Withholding and Estimated Tax.

Recharacterizations

You may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution.

To recharacterize a contribution, you generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for your tax return for the tax year during which the contribution was made, you can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. If you recharacterize your contribution, you must do all three of the following. Include in the transfer any net income allocable to the contribution. If there was a loss, the net income you must transfer may be a negative amount. Report the recharacterization on your tax return for the year during which the contribution was made. Treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

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

Pensions

A pension plan is a deferred compensation arrangement that provides for systematic payment of definitely determinable retirement benefits to employees who meet the plan's requirement. Benefits are based on such factors as years of service and compensation received by the employees.

(1) A pension plan may provide for payments due to disability and for incidental death benefits through insurance.

(2)A defined benefit plan must expressly provide that forfeitures cannot be applied to increase the benefits any employee would otherwise receive.

Pensions

Employer contributions under a pension plan must not depend on profits, and any contributions must be sufficient to provide definitely determinable benefits based on some actuarial computation (except for a defined contribution pension plan).

Pensions

Employer contributions. A defined contribution plan defines the amount the employer is required to contribute, such as a flat dollar amount, an amount calculated by a special formula, or a certain percentage of compensation.

- Thus, actuarial calculations are not required in order to determine the employer's annual contribution.
- At retirement, the employee receives whatever pension his or her account will purchase.
- Employee contributions may be required or permitted. The term “defined contribution” includes a money purchase plan, a profit sharing plan, a stock bonus plan, and a target-benefit plan.

Pensions

Defined benefit plan. A defined benefit plan is based on a formula which defines the benefits the covered employees are to receive in the future.

Employer contributions. An employer must contribute each year an amount actuarially computed to make satisfactory progress toward an amount to pay the pensions as they become due.

Annuities

An annuity is a series of equal payments received at set time intervals for a determinable period. An Annuity contract generally requires the purchaser (the annuitant) to pay a fixed amount for the right to receive a future stream of payments. Accounting for an annuity is much the same as accounting for depreciable assets. That is, the cost of the asset is allocated over its estimated life.

Capital Recovery Concept

- Excludes the amount of original investment from taxable income
- Must be spread over the time of receipt

Annuity Exclusions

If the payment term and amount are fixed:

$$\text{Exclusion Ratio} = \frac{\text{Cost of the contract}}{\text{Total expected return}}$$

Annuity Exclusions

If the payment term depends on the life of the taxpayer the taxpayer must estimate the number of payments,

or

Use the “simplified method”

Non-Employer Sponsored Retirement Plans

Taxpayers who do not have access to an employer sponsored pension plan are allowed several options:

- Keogh or H.R.10 plans (for self-employed taxpayers only)
- Individual Retirement Accounts (for all taxpayers)

7. Required Minimum Distributions and Excess Accumulations

Uniform Minimum Distribution Rules. Uniform minimum distribution rules exist for all qualified defined benefit and defined contribution plans.

Age 70 1/2 and April 1 deadline. Distributions must commence no later than April 1 of the calendar year following the later of:

- the calendar year in which the employee attains age 70 1/2
- the calendar year in which the employee retires.

8. Loans from IRC section 401(k) plans and other qualified plans

Retirement plans may offer loans to participants, but a plan sponsor is not required to include loan provisions in its plan. Profit-sharing, money purchase, 401(k), 403(b) and 457(b) plans may offer loans. To determine if a plan offers loans, check with the plan sponsor or the Summary Plan Description.

IRAs and IRA-based plans (SEP, SIMPLE IRA and SARSEP plans) cannot offer participant loans. A loan from an IRA or IRA-based plan would result in a prohibited transaction.

Loans from IRC section 401(k) plans and other qualified plans

To receive a plan loan, a participant must apply for the loan and the loan must meet certain requirements. The participant should receive information from the plan administrator describing the availability of and terms for obtaining a loan.

Maximum loan amount

The maximum amount a participant may borrow from his or her plan is 50% of his or her vested account balance or $50,000, whichever is less. An exception to this limit is if 50% of the vested account balance is less than $10,000: in such case, the participant may borrow up to $10,000. Plans are not required to include this exception.

Loans from IRC section 401(k) plans and other qualified plans

Examples:

Bill's vested account balance is $80,000. Bill may take a loan up to $40,000, which is the lesser of 50% of his vested account balance and $50,000.

Sue has a vested account balance of $120,000. Sue may take a loan up to $50,000, which is the lesser of 50% of her vested account balance of $120,000 ($60,000) or $50,000.

Repayment periods

Generally, the employee must repay a plan loan within five years and must make payments at least quarterly. The law provides an exception to the 5-year requirement if the employee uses the loan to purchase a primary residence.

Loans to an employee that leaves the company

Plan sponsors may require an employee to repay completely a loan if he or she terminates employment. If the employee is unable to repay the loan, then the employer will treat it as a distribution and will report it to the IRS on Form 1099-R. The employee can avoid the immediate income tax consequences if he or she is able to come up with the loan's outstanding balance, within 60 days and rolls over this amount to an IRA or eligible retirement plan.

9. Taxability of Social Security Benefits

A portion of Social Security benefits received may be taxable if modified AGI exceeds certain limits

Adjusted gross income
plus: 1/2 social security benefits received
plus: tax exempt income
plus: foreign earned income exclusions
Modified AGI

Social Security Benefits

Example:

Susan, a single taxpayer received $3,000 from Social Security payments. Her AGI without the Social Security is $30,000. She has neither tax exempt interest nor foreign earned income.

Modified AGI = $30,000 + $1,500

= $31,500

50% Formula Example

Going back to Susan, our single taxpayer

With modified AGI = $31,500, the taxable portion of her $3,000 Social Security income is the lesser of:

$1,500, or

1/2 ($31,500 - $25,000) = $3,250

Therefore, taxable SS is $1,500

Social Security Benefits: 50% Formula

Affects:

MFJ taxpayers with modified AGI between $32,000 (the base amount) and $44,000

Unmarried taxpayers with modified AGI between $25,000 (the base amount) and $34,000

Others with modified AGI of more than $0

Calculation:

The taxable portion of Social Security is equal to the lesser of:

- 1/2 Social Security received, OR
- 1/2 of the amount by which modified AGI exceeds the base amount.

Social Security Benefits: Second Tier

For taxpayers whose income exceeds the 50% formula amounts the taxable portion of Social Security is equal to the lesser of:

85% of Social Security received, or

85% of the amount by which modified AGI exceeds the base amount, **plus** the smaller of the amount of SS benefits included under the 50% formula, or $4,500 for unmarried individuals ($6,000 for MFJ) Where the base amounts are $34,000 for unmarried individuals;

$44,000 for MFJ;$0 for others

Second Tier Example

If Mary receives Social Security of $12,000 and has AGI of $50,000 before SS:

Modified AGI = $50,000 + $6,000 = $56,000

Taxable SS is $10,200, which is the smaller of:

- .85($12,000) = $10,200, or
- [.85 ($56,000 - $34,000)] + [(1/2 of $12,000 SS) = $4,500]

= $18,700 + $4,500

= $23,200