Complex rules raise numerous questions about deductible and non-deductible IRAs, rollovers, withdrawals, minimum distributions and beneficiary designations.

Straightforward Answers to Common Questions on Retirement Plan Rules

By Clark M. Blackman II and Kevin P. McAuliffe

Over the past year and a half, we have addressed many of the rules, issues and penalties relating to retirement plans and IRAs. As one might expect, a number of questions have been raised by readers on these and related topics. This article will address those questions we feel have broad applicability.

Deductible IRAs

When can someone set up a deductible IRA?

In general, each year an individual may contribute 100% of compensation up to a maximum of $2,000 to an IRA. The contribution limit is $2,250 if a spousal IRA is also established for a non-working spouse.

For deductible IRAs, under current tax law if neither you nor your spouse participate in an employer-maintained retirement plan (including a 401(k) plan), you may contribute and deduct on your tax return up to $2,000 for yourself and $2,000 for your spouse. If your spouse is not employed, then his or her contribution is reduced to $250.

If you or your spouse actively participates in an employer-maintained retirement plan, then another set of rules applies. The IRS says that if you're single and an active participant, you may deduct your full contribution only if your "modified adjusted gross income" (MAGI) is $25,000 or less. Your deduction is reduced $10 for each $50 you earn above $25,000 until you hit $35,000, when the deduction phases out entirely.

If you're married and file jointly and either one of you is an active participant, you get a full deduction only if your MAGI is $40,000 or less. Your deduction drops by $10 for each additional $50 in income up to $50,000, when the deduction vanishes. Filing separately won't help. If married couples who live together file separately, no deduction is allowable to either person. Table 1 summarizes how these rules work.

For purposes of these limits, modified adjusted gross income is calculated without including any deductible IRA contributions, exclusions for foreign earned income and U.S. savings bond redemptions (described in IRS publication 590), but including any taxable Social Security benefits and tax-exempt interest.

What is an "active participant in a tax qualified plan"?

When it comes to the active participation rules, several types of plans fall into the category of qualified or tax-favored plans; any of the plans in Table 2 are counted. If you participate in any one of them, the law considers you an active participant, and that means you can't deduct your IRA contribution—unless your MAGI is under the above thresholds.

How do you know if you're an active participant?

Look at your W-2 Form. It includes a box entitled "Pension plan" for your employer to check. If the box is checked, you know you're an active participant. If this box is blank, you'll need to understand the "active participation" rules.

The IRS says it makes no difference whether you actually participate in a defined-benefit retirement plan (plans in which your benefit is based on your salary and number of years of employment with the firm); it matters only that you're eligible to participate. However, the rules are different for a defined-contribution plan (plans in which your benefit is based on contributions to the plan by you or your employer). Here you're considered an active participant if during the year, you or your company contribute money to the plan on your behalf. However, if you are eligible to make a contribution and choose to not do so (and your employer does not contribute on your behalf), you are not an active participant. Furthermore, you are not considered an active participant if the only money that is added on your behalf during the year are earnings from the investments already in the plan.

Clark M. Blackman II, CPA/PFS, CFA, is Price Waterhouse LLP director of Personal Financial Services in Houston (713/654-4100). Kevin P. McAuliffe, JD, CPA/PFS, LLM (Taxation), is director of Personal Financial Services in Price Waterhouse's Chicago office (312/540-1500).

Table 1.
Available IRA Deductions

Modified Adjusted Gross Income	Type of Filing: Single/Head of Houshold	Married-Joint	Married-Single
$0-$10,000	Full	Full	Partial
$10,000-$25,000	Full	Full	None
$25,000-$35,000	Partial	Full	None
$35,000-$40,000	None	Full	None
$40,000-$50,000	None	Partial	None
$50,000+	None	None	None

** If you actively participate in a company retirement plan.*

On the other hand, in the eyes of the IRS you're an active participant if you take part in a retirement plan for just part of the year. For example, assume that you changed jobs in November 1995 and moved from Old Company Inc. to New Corp. You are not eligible for the New Corp pension plan in 1996, so you make what you think is a deductible IRA contribution for 1996. However, Old Company's pension plan does not end its tax year until January 31, 1996. Therefore, you are eligible and active in that plan for the first month of the 1996 year. Thus, you are considered to be an active participant for 1996.

What if you contribute to an IRA and make a mistake? What about investment returns on the mistake?

If you contribute more to an IRA than the amount allowed ($2,000 per individual, or $2,250 if the spouse does not have earned income), the excess contribution is subject to a 6% excise tax. Furthermore, the IRS can assess the penalty each year the excess contribution remains in the IRA. You can avoid the penalty by withdrawing the excess contribution, along with the earnings attributable to the contributions, before the due date (including extensions) of your tax return for the year of the excess contribution.

Of course, if you mistakenly deduct a contribution that is not deductible, you should amend your tax return for the year of the contribution and pay any additional taxes. But you do not have to remove the contributions or investment earnings from the IRA, as long as your contribution did not exceed the above limits.

Non-deductible IRAs

How do you keep track of your basis in a non-deductible IRA?

IRS Form 8606 provides a way of tracking your IRA basis from year to year. If you set up a non-deductible IRA, the IRS requires you to file Form 8606 each year with your return to track the contributions that are non-deductible and hence would represent a return of basis when distributed. The form requests the following information:

- Non-deductible contributions for the year;
- The amount of distributions from IRAs for the year;
- The excess (if any) of (a) the amount of non-deductible contributions for all preceding taxable years, over (b) the amount of distributions from IRAs that were excluded from gross income for such taxable years; and
- The balance of all IRAs of the individual as of the end of the taxable year.

If this information is not provided, then all IRA contributions are considered to have been deductible and, therefore, are taxable as income upon withdrawal from the IRA. There is a $50 penalty for failure to report the required information, and a $100 penalty for overstating the amount of designated non-deductible contributions—unless you can show that the error was due to reasonable cause.

When withdrawing from deductible and non-deductible IRAs, how do you determine how much comes from each?

The amount included in your income is determined by subtracting from the amount of the IRA withdrawal an amount that bears the same ratio to the amount withdrawn as your total non-deductible IRA contributions bear to the balance of all IRAs. The formula for determining the non-taxable portion of an IRA distribution is:

$$\frac{\text{Total non-deductible contributions}}{\text{Total of IRA account balances plus amount of IRA distributions}} \times \text{IRA distributions} = \text{Non-taxable portion of distribution}$$

Transfers/Rollovers

What's the difference between a transfer and a rollover?

The law allows for two types of IRA transfers. The first is known as a direct trustee-to-trustee transfer; the second is known as a rollover. Much of the confusion on this issue arises because, in IRS lingo, these are both technically considered to be "rollovers." However, in a trustee-to-trustee transfer (also known as a direct rollover), you never get your hands on your IRA funds; instead you tell the institution that maintains your IRA to send the funds in your account to an IRA at a second institution, or you are sent a check made out to the second institution. Either way, you don't get your hands on the money because there is no check made out to you.

You can transfer your IRA in this way as many times as you like during the year. Likewise, you won't be hit with a penalty if you shift funds from one investment vehicle to another within the same institution again, as long as you never withdraw the money yourself. In other words, if you maintain an IRA at a financial institution that offers a number of investment vehicles, you may shift funds from one vehicle to another within that institution as many times as you choose, without penalty.

The rules are different for a non-direct rollover IRA. In this case, you actually withdraw your money from your IRA and deposit it in another IRA account. The key distinction is that the money is, at least temporarily, in your possession. You have only 60 days to deposit your money into another IRA. If you miss the 60-day deadline, the IRS will assume you've made a withdrawal and tax you currently on the amount, and you will not be able to put the money back into the IRA. You may also pay a 10% early withdrawal penalty on the amount you've withdrawn if you are not yet 59½.

Furthermore, you may withdraw your money and roll it over into another IRA only once in a 365-day period. The 365-day rule applies separately to each IRA. You can avoid this whole problem by using a trustee-to-trustee transfer, in which you instruct your IRA trustee to forward your funds to another IRA trustee. In this way, you never have "touched" the money, therefore, the 365-day rule does not apply.

How do you avoid withholding on your retirement plan proceeds when you change jobs?

In order to avoid withholding at a mandatory 20% rate, you must roll over the entire distribution from your old employer's plan either into a rollover IRA or your new employer's plan, if that is permitted by the plan. But remember, there are two ways that you can roll a distribution over into an IRA. The first way is to actually receive the money and within 60 days deposit that money into an IRA; the second way is a direct rollover (trustee-to-trustee transfer) where your company plan trustee sends the money directly to your IRA and you never get your hands on the money. If you choose to receive the funds yourself, the law requires your employer to withhold 20% of your distribution for federal taxes. So if you have a $50,000 lump-sum distribution, the amount you receive will only be $40,000 ($50,000 less the 20% withholding of $10,000, which will be sent to the IRS). Thus, you will only have $40,000 to roll over. If you don't come up with the additional $10,000 out of your own pocket and put it into the IRA, then that $10,000 will be considered a taxable distribution, even though part of it may be refunded to you when you file your tax return. And it might also be subject to a 10% penalty if you received your distribution before you are 59½.

According to the IRS, a direct rollover may be accomplished by any reasonable means of direct payment, including a wire transfer or the mailing of a check to the eligible retirement plan. If the payment is made by wire transfer, the wire transfer must be directed only to the trustee of the eligible retirement plan. If payment is made by check, the check must be negotiable only by the trustee of the eligible retirement plan and should be addressed as follows: "[Name of the trustee] as trustee of [name of eligible retirement plan]." For example, if the name of the IRA is "Individual Retirement Account of John Doe" and the name of the trustee is "ABC Bank," the payee of the check should read "ABC Bank as trustee of Individual Retirement Account of John Doe."

If the plan is not an IRA, the payee line of the check need not identify the trustee by name and may read "Trustee of the XYZ Corporation Savings Plan for benefit of John Doe."

If you roll your retirement plan assets over, when does the 60-day time period begin?

It depends on whether you are making a direct rollover or you actually receive the money. If it is a direct rollover, the 60-day rule does not apply because distribution and rollover are considered to be simultaneous. However, if you receive the money, the 60-day period begins on the date the distribution is received. IRS has held that if a distribution is received in more than one payment, for purposes of the 60-day rollover period you are deemed to have received all distributions on the day the last payment is received.

What if there is a delay in receiving the proceeds of a direct rollover—can other money be used to set up a new account?

Generally, this would not be a problem since the 60-day rule does not apply. However, the administrator of the plan will only be liable if you provide adequate information and it fails to make a rollover. The administrator is not required to verify independently the accuracy of information, as long as it is not clearly erroneous.

To avoid liability, the plan administrator must have been furnished with the name of the IRA or qualified plan to receive the distribution; a representation that the recipient plan is an IRA, a tax-sheltered annuity, or a qualified plan; and any information necessary to permit the plan administrator to accomplish the direct rollover (i.e., the name and address of the recipient trustee).

When receiving lump-sum distributions from an employer, can an individual take a partial distribution and roll the remainder over?

Yes, but the part of the lump-sum distribution that is not rolled over is subject to regular income tax in the year received, as well as a 10% early

Table 2.
Tax Qualified Plans

(If you participate in one of these types of plans, you are an "active participant.")

- Qualified pension, profit-sharing, or stock bonus plans, including Keogh plans
- 401(k) plans
- Simplified employee pension plans (SEPs)
- Retirement plans for federal, state, or local government employees
- Tax-sheltered annuities for public school teachers and employees of charitable organizations
- Deferred compensation plans for state employees
- Collectively-bargained (union) plans

withdrawal penalty if you are not yet age 59½ (or 55 in the case of the early retirement from the employer).

Withdrawals

When can withdrawals begin prior to age 59½ and not be subject to the 10% penalty?

In general, the IRS allows distributions from IRAs and employer-sponsored plans free of the 10% penalty when the distributions:

- Follow the death of the owner;
- Follow the disability of the owner; or
- Represent payments from a series of "Substantially Equal Periodic Payments," lasting for a period of at least five years, but in no event ending before age 59½. (For more on this method, see the August 1995 Retirement Plans column.]

In addition, distributions from an employer-sponsored plan may avoid the 10% penalty if the distributions:

- Are made to an individual who retired during the year he or she turned 55, or any time thereafter;
- Are for medical expenses exceeding 7.5% of adjusted gross income;
- Are payments to an alternate payee resulting from a court ordered "Qualified Domestic Relations Order" (QDRO).

In addition, any amount subject to the 15% excess distribution tax will not also be subject to the 10% early distribution rate.

How do you make an early withdrawal from an IRA? Can you take a partial withdrawal or do you have to withdraw the entire IRA?

There is no formality to taking an early IRA withdrawal—you simply withdraw what you need, when you need it, and if you can't find an exception to fit under, pay the penalty with the filing of your Form 1040 tax return.

How is the 10% penalty assessed? Is it before income taxes or after income taxes? If before income taxes, can you deduct the penalty before assessing the income tax?

The 10% penalty for early withdrawal is calculated using IRS Form 5329. The full amount of the distribution is subject to both the income tax and the excise tax; i.e., no deduction against either tax is allowed.

For example: You take $2,000 from your IRA before 59½ and do not meet any of the criteria for avoiding the penalty. If you are in the 28% tax bracket you will pay:

Income Tax	$560 (28% × $2,000)	28%
Excise Tax	$200 (10% × $2,000)	10%
Total Taxes	$760	38%

Age 70½ and the Minimum Distribution Rules

If you have several IRAs, can the required minimum distribution for all be withdrawn from just one IRA?

Yes, the rules only require that the total needs to be withdrawn for the year. However, if your IRAs have different beneficiary designations or life expectancy calculation options, you should distribute the appropriate amount from each different "set" of IRAs.

What plans must be included in calculating minimum distributions?

In determining the amount of your minimum required distribution, you must include the following in your calculation:

- Any and all company-sponsored qualified plan assets (e.g., 401(k), profit sharing, pension lump sums, etc.) other than those that are being paid out as a life annuity (i.e., pension payments). These payments must start no later than the minimum distribution date.
- All IRA balances, including contributions that did not provide a tax deduction (non-deductible IRA contributions discussed earlier).
- Tax-sheltered annuities and certain commercial annuities are included in the minimum distribution calculation to the extent that they have not been annuitized. Tax-sheltered annuities are essentially employer provided plans where the employer is a non-profit organization under Internal Revenue Code Section 501(c)(3) or a public school. Certain types of commercial (insurance company) annuities may also be included if they have not yet been annuitized.
- Certain insurance company endowment contracts.

Can you continue to contribute to an IRA after age 70½?

No, you may not make any deductible qualified plan/IRA contributions the year you turn 70½, or any year thereafter.

Naming Beneficiaries

What are some 'simple' guidelines for naming beneficiaries?

This a very complex area that we addressed this year in some detail in the April and June issues of the *AAII Journal*. However, here are some guidelines to think about.

Naming a surviving spouse as beneficiary may be necessary if the assets are required for support. This also can provide numerous benefits:

- These assets are not subject to estate tax at the death of the first spouse to die.
- These assets can avoid the excess accumulations tax penalty if an election is made on the estate tax return and at least 99% of all assets subject to the penalty are transferred to the spouse.
- The surviving spouse may roll the proceeds into a new IRA, with the survivor becoming the designated owner.

Naming an estate or non-qualified trust as beneficiary will require that all assets be distributed, and income tax paid, by December 31 of the fifth year anniversary of the date of death, if death is before minimum distributions are required to begin.

Naming non-spouse individuals can provide an income tax benefit by allowing those individuals to take annual distributions (beginning the calendar year following the date of death) over their life expectancy as of the date of death. Remember though, if naming a young child or grandchild, these rules only set a minimum on distributions, not a maximum on distributions allowed. This strategy does not replace the need for a trust when young or incompetent beneficiaries are involved.

Naming a qualified trust specifically set up to follow the regulations set forth by the Treasury can provide many of the same benefits as noted above for both spouse and non-spouse beneficiaries (in several instances, the IRS has allowed spousal rollover rules to apply in several Private Letter Rulings. However, they have disallowed rollovers in other rulings). The benefit of using the trust is that you are able to detail specific distributions and accumulations guidelines which must be followed.

If you are young, should you worry about beneficiary designations?

Yes. The rules mentioned above generally apply whether you are 28 or 80.

Can you change beneficiaries?

Yes. Anytime prior to your required minimum distribution beginning date, you may change beneficiaries without consequence. Your required beginning date is April 1 of the year following the year you turn age 70½ (on which date you could be age 70 or 71.) After that date, you may change beneficiaries, but you may not change minimum distributions during the life of the owner—in other words, the distribution method chosen at the required beginning date, which may be based on the beneficiary designation, is irrevocable and unchangeable. However, unless the change is the result of the death of the initial beneficiary, a new beneficiary with a shorter life expectancy will require minimum distributions to be accelerated.

In the case of the death of the named beneficiary at the required beginning date, distributions will continue as if the beneficiary had not died. However, if the deceased beneficiary was the spouse and his or her life expectancy was being recalculated, then life expectancy will be treated as zero in the years following the year of death.

Does the IRA beneficiary designation need to be mentioned in your will?

No. Wills only affect assets passing through probate. Beneficiary designations supersede anything your will might dictate. Only if you designate the estate as a beneficiary will your estate planning documents apply.