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Roth IRA owners must be 59½ or older and have held the IRA for five years before tax-free withdrawals are permitted. Additionally, each converted amount may be subject to its own five-year holding period. Converting a traditional IRA into a Roth IRA has tax implications. Investors should consult a tax advisor before deciding to do a conversion.

IRAs and Federal Employees

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IRAs and Federal Employees

Introduction

Individual Retirement Accounts (IRA) have been available to all working individuals since 1974. At that time, Congress passed legislation creating IRA's in order to help workers supplement their existing pension plans, or in some situations, to serve as a sole means of a worker's retirement savings plan.

There have been several legislative changes to IRA's since their initial establishment in 1974. Among these changes is that since 1986, workers who are covered by qualified retirement plans may not be able to deduct their IRA contributions on their income taxes (as an adjustment to income). While many employees have and continue to fund their IRA's, there are those who have stopped contributing as a result of not being able to deduct their contributions (as they can with their contributions to the Thrift Savings Plan).

Another possible reason for the lack of participation in funding IRA's among employees is a misunderstanding of what IRA's are as well as who is eligible to establish and contribute to them. For example, there are some employees who mistakenly believe that because they are covered by a qualified retirement plan and (such as a 401(k)) then they are ineligible to contribute to an IRA. Nothing could be further from the truth. Any employee, whether the employee earns $300 or $3,000,000 a year, is eligible to contribute to some type of IRA.

In addition to providing another source for retirement, IRA's may also be used (with limitation) to fund the purchase of a first house and the payment of a dependent's college expenses. Most of these new opportunities have come about following the passage of the Taxpayer Relief Act of 1997.

In this publication, all of the many opportunities available to employees for contributing to, maintaining, and ultimately using their IRA's will be discussed. At a time when many Americans are discovering (in some cases, too late), that have not saved enough for their retirement, IRA's represent a great opportunity for employees to ensure their financial security during retirement.

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Chapter 1. What is an Individual Retirement Arrangement (IRA)?

Since 1974, the acronym "IRA" has historically been referred to as an Individual Retirement Account or Annuity, established and maintained by an individual for his or her own benefit. However, that definition is currently too restricted. This is because Congress has expanded the use of the term IRA to describe any type of individual savings plan receiving federal tax benefits.

Individuals who work, or who are married to working spouses are authorized to open IRA's and to obtain federal (and often state) tax benefits. The tax-favored status of an IRA, along with the rules that accompany that status, are what distinguish any type of IRA from a general savings plan that an individual may have.

Different Types of IRAs That Individuals May Own

There are five types of IRAs that individuals may own. Here are the five, with a brief description of each:

- **Traditional IRA.** The traditional IRA, created in 1974, may be either a deductible or a nondeductible IRA. For **2019 and 2020**, the annual contribution to a traditional IRA is limited to $6,000; (for those individuals who are at least age 50 as of **12/31/2020**, an additional contribution of $1,000 may be made during **2020** allowing those individuals to contribute a maximum $7,000 to their IRAs for **2020**. The issue of whether or not one's IRA contribution is deductible depends on one's modified adjusted gross income (MAGI) (see Chapter 6). Earnings in a traditional IRA grow tax-deferred. Individuals generally cannot access their traditional IRAs without penalty until they are age 59.5.

- **Roth IRA.** A Roth IRA is a type of nondeductible IRA. However, its key feature (that differentiates it from a traditional, nondeductible IRA) is that the earnings in the account are potentially tax-free at the time of distribution. In other words, individuals taking qualified distributions from a Roth IRA do not have to pay federal (and in most cases, state) income taxes at the time of distribution. Also, the Roth IRA is more accessible than the traditional IRA; individuals may take a distribution of their principal amount (contributions) at any time, for any reason, and without penalty. Earnings in a Roth IRA (interest, dividends, capital gains) may also be withdrawn tax-free before age 59.5 in order to pay higher education expenses of a relative, to pay the expenses for the purchase of a first home, or to pay expenses related to a total disability. The Roth IRAs have the same annual contribution limits as the traditional IRAs.

IRAs and Federal Employees

• **Coverdell Educational Savings Account.** A Coverdell Education Savings Account or CESA is a trust or custodial account designed to help pay higher education costs. It allows an individual to make a nondeductible contribution on behalf of a child (younger than 18). Until 2002, the maximum educational IRA contribution was $500 per child per year; starting in 2002, the maximum annual contribution per child increased to $2,000. The CESA is a different type of IRA in that its sole purpose is to save for a child's education expenses. This includes qualifying educational expenses for nursery school, parochial and private school grades 1 to 12 (as well as for post-high school).

• **Simplified Employee Pension (SEP)-IRA Plan.** A SEP is an employer retirement plan that allows an employer to make contributions into the traditional IRAs of its employees. Although a SEP is not an IRA, traditional IRAs that receive employer SEP contributions are often referred to as SEP IRAs. Many individuals who are employed in second jobs or started businesses on their own are participating in SEP plans.

• **Savings Incentive Match Plan for Employees (SIMPLE) IRA.** A SIMPLE IRA is a special type of IRA that can receive only employer contributions and employee salary deferrals. (SIMPLE is an acronym for savings incentive match plan for employees). A SIMPLE plan is similar in concept to a SEP. There are many Federal employees who may participate in SIMPLE plans as part of their additional employment with a private employer.

In addition to an individual retirement account (governed by Internal Revenue Code Sections 408 and 408A), there is an individual retirement annuity. An individual retirement annuity is another type of a traditional IRA that is issued by an insurance company qualified to do business under the laws of the jurisdiction where the contract is sold.

The various types of IRAs available to individuals (except for SEPs and SIMPLEs) are summarized in Table 1. From time to time throughout this publication Table 1 will be referenced with respect to a particular aspect of an IRA.

IRAs and Federal Employees

Table 1. Comparison of IRAs (2020 Limits are Shown)

2020 IRA Comparison Chart					
	Traditional Deductible IRA	**Spousal IRA**	**Traditional Nondeductible IRA**	**Roth IRA**	**Coverdell Educational Savings Account (Educational IRA)**
Qualifications to Make Contributions	Must have earned income or a spouse must have earned income.	A spouse can make contributions based on other spouse's earned income.	Individual (or spouse) must have earned income.	Individual (or spouse) must have earned income. May be any age (including 70.5).	Beneficiary of Educational IRA must be under 18
Income (MAGI) Limitations	If active participant in employer retirement plan, subject to MAGI* phase out rules for – MFJ: **$104,000 - $124,000;** Single & HOH: **$65,000 – 75,000**; No limits for individuals not actively participating in employer retirement plan.	If working spouse is an active participant in an employer plan, the nonworking spouse's IRA is phased out when MAGI* is between **$196,000 - $206,000**	No Limitations.	Regardless of coverage by employer retirement plan, subject to MAGI*phase-out rules: MFJ: $**196,000- $206,000** Single & HOH & QW: $**122,000 - $137,000** MFS: $0 - $10,000	Contributor is subject to MAGI*phase-out rules: MFJ: $**190,000 - $220,000** Single & HOH & MFS & QW: **$95,009 - $110,000**
Contribution Limit	Lesser of $6,000 or taxable compensation. Coordination of IRAs: Limit applies to any combination of IRA plans (other than Coverdell IRA). This means the maximum total yearly contributions to all IRAs are $6,000. (The limit is $7,000 for individuals who are at least age 50 by Dec. 31, 2020)				Limited to $2,000 per year per beneficiary. Contributions do not count against the limits for other IRAs.

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Tax Treatment of Qualified Distributions	All distributions are taxable.	All distributions are taxable.	Cost basis portion of distribution is tax free; earnings portion is taxable	Qualified distributions are nontaxable (including earnings). Certain nonqualified distributions are not subject to the 10% penalty, but the earnings portion is taxable.	Qualified distributions are nontaxable (including earnings).

Table 1. Comparison of IRAs (continued)

2020 IRA Comparison Chart					
	Traditional Deductible IRA	**Spousal IRA**	**Traditional Nondeductible IRA**	**Roth IRA**	**Coverdell Educational Savings Account (Educational IRA)**
Allowable Distributions (Not Subject to 10% Penalty)	Under current law allowable distributions (not subject to the 10% penalty) include: (1) Participant over age 59 ½. (2) Death or disability of participant. (3) Series of substantially equal payments over life of participant (or joint lives of participant and beneficiary). 4) Payment of qualified medical expenses that exceed 7.5% of AGI. 5) Payment of health insurance premiums for certain unemployed individuals. 6) Payment of qualified college expenses 7) Payment of qualified first-time home purchases (8) Payment due to IRS levy			•Qualified distributions are not allowed during first 5 years of plan. Entire distribution is nontaxable for: 1) Participant over age 59.5 2) Death or disability of participant. 3) Qualified first-time home purchase. • Earnings portion of nonqualified distribution is taxable (but penalty free) for: 1) Qualified college expenses. 2) Qualified medical expenses that exceed 10.0 % of AGI. 3) Substantially equal payments over life of participant. 4) Health insurance premiums for certain unemployed individuals. 5) Distribution due to IRS levy.	For payment of qualified college expenses.
Penalties	10% penalty is applied to all distributions that are not qualified under a Code Section 72(t) exception. 6% penalty on all excess contributions.				

Required Distributions	Must begin by April 1 following the year the IRA owner becomes age 70.5 (if born before 7/1/1949; by April 1 following the year the IRA owner becomes age 72 (if born after 6/30/1949)		Distributions are required only after the death of participant.	Must be complete before beneficiary reaches age 30.
Rollovers And Conversions	Traditional IRAs may be rolled into traditional IRAs. Roth IRAs may be rolled to Roth IRA. Traditional IRA funds may be converted to Roth IRAs penalty free: 1) Conversions are subject to income tax. 2) Any individual - no matter what their income, filing status, or age - may convert a traditional IRA to a Roth IRA.	Traditional IRAs may be rolled into traditional IRA. Traditional IRA funds may be converted to Roth IRAs penalty free: 1) Conversions are subject to income tax. 2) Any individual - no matter what their income, filing status, or age - may convert a traditional IRA to a Roth IRA.	Funds from one Roth IRA may be rolled over tax-free into another Roth IRA.	May be rolled over tax free to another Coverdell IRA. May also be rolled into a Coverdell IRA for another beneficiary in the same family.

***Modified Adjusted Gross Income = Adjusted Gross Income + Student Loan Interest Deduction + Tuition and Fees Deduction + Foreign Earned Income Exclusion + Foreign Housing Exclusion or Deduction + Excluded EE Savings Bond Interest Shown on Form 8815**

The main benefits to IRAs that are most appealing to individuals are the tax benefits. All types of IRAs share one common tax characteristic: their earnings grow at least tax deferred. From that common base, the tax benefits of the various IRAs are different.

With a traditional IRA, individuals may be eligible for a tax deduction for their contribution, but distributions from a deductible, traditional IRA are generally subject to taxation. As will be discussed in Chapter 2, many federal employees are not eligible to make a traditional *deductible* IRA contribution; however, if they younger than age 70.5 then they are always eligible to make a traditional *nondeductible* IRA contribution. And if MAGI does not exceed the limits, they can make a Roth IRA contribution no matter their age (even past age 70.5)

Chapter 2. Traditional IRA versus Roth IRA

The term, traditional IRA, simply refers to an IRA that is not a Roth IRA, an Educational IRA, a SEP IRA, or a SIMPLE IRA. A traditional IRA can be further classified as a deductible or nondeductible IRA. Furthermore, as shown in Table 1, a traditional IRA can also be classified as a spousal IRA in which a nonworking spouse contributes to his or her IRA. In other words, with either a traditional or a Roth IRA, only one spouse needs to have earned income in order for both spouses to contribute in any year to their respective IRA's.

Whether or not an individual may deduct on their federal and state income taxes (as an adjustment to income) a traditional IRA contribution depends on the following:

- The individual's status as an active participant in a qualified retirement plan or the employee's spouse status in an employer sponsored retirement plan and;
- The individual's modified adjusted gross income (MAGI) (see below); and
- The individual's filing status.

MAGI for purposes of determining the deductibility of a traditional IRA contribution is defined as one's adjusted gross income (which can be determined from the last line of page 1 of Form 1040 or Form 1040A) with the following amounts added back:

- Student loan interest deduction;
- Savings bond excluded interest;
- Foreign earned-income exclusion;
- Foreign housing exclusion;
- Tuition and fees deduction

The MAGI thresholds for deductibility of traditional IRA contributions were changed as part of the Taxpayer Relief Act of 1997. These limits usually increase each year and are shown in Table 2. Federal employees should locate their MAGI in Table 2 for 2020 under the appropriate filing status.

Table 2. Phaseout Ranges for Deductible Traditional IRA Contributions Using MAGI

The deduction for an IRA contribution for an individual covered by a pension plan is subject to phase-out at the 2020 MAGI amounts
If married and spouse not covered by pension plan: Married Filing Jointly: $196,000 and $206,000 Married Filing Separately: $0 - $10,000 If married and spouse covered by pension plan: Married Filing Jointly: $104,000 to $124,000 Married Filing Separately: $0 - $10,000 Filing as Single or Head of Household: $65,000 and $75,000

An individual may elect to deduct (an adjustment to income) less than the permitted deduction for a traditional IRA contribution and increase the nondeductible portion correspondingly. Remember that an individual may own as many IRAs (deductible, nondeductible or Roth) as they want; may contribute the maximum allowed to any one IRA during ($6,000 or $7,000 if age 50 or older); he or she may contribute to all of them so as the total contribution doesn't exceed the maximum allowed for any year. In the case of a spousal IRA, each spouse determines the deductible amount separately.

A *nondeductible* IRA is a traditional IRA in which an individual is unable to deduct the contribution to the IRA on their income tax return. The main reason an individual would not be able to deduct the contribution is that under current rules, if an individual is covered by or participates in a qualified retirement plan and their MAGI exceeds certain limits in the year of contribution, then their contribution will not be deductible. These limits are shown in Table 2 are for tax year **2020**. Note the upper and lower MAGI limits; an individual whose **2020** MAGI falls below the appropriate lower limit would be able to deduct their entire traditional IRA contribution while if their MAGI falls above the appropriate upper limit then no deduction is permitted. An individual whose MAGI is in-between would be able to partially deduct an IRA contribution, as the following example illustrates:

Example. Julie, age 35, single and works for the federal government, has MAGI of $70,000 during 2020. Julie contributes the maximum allowed of $6,000 to her traditional IRA during 2020. She also participates in the traditional Thrift Savings Plan and is covered by FERS. Since Julie's MAGI is halfway between the beginning ($65,001) and end ($75,000) of the MAGI phaseout, she will be able to deduct half ($3,000) of her IRA contribution on her 2020 Federal income taxes. *Note: the fact that Julie contributed to the traditional Thrift Savings Plan reduced her MAGI, thereby resulting in her being able to deduct more of her IRA contribution.*

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The following eight rules apply to a traditional IRA contribution that follows between the full-deduction and no-deduction levels:

1. The reduction in the deduction applies ratably. For example, a contribution will be 50 percent deductible if the MAGI falls at the midpoint of the range; that is, an individual IRA with a maximum contribution will be deductible in the amount of $3,000 and nondeductible in the amount of $3,000 (for the year 2020 and for someone younger than age 50 as 12/31/2020).

2. IRS Publication 590-A (Contributions to Individual Retirement Arrangements) (downloadable from https://www.irs.gov/pub/irs-pdf/p590a.pdf) has worksheets which allow individuals to compute the deductible portion of an IRA contribution. The portion that is not deductible is considered to be nondeductible.

3. If any amount remains deductible, $200 is the minimum deductible amount.

4. In the case of a spousal IRA, the $200 minimum applies to the total deduction on the return. In the case of a joint return in which each spouse is working and contributes to a separate IRA for himself or herself, the $200 minimum applies separately to each.

5. If the reduction applies so that one spouse has over-deducted (as on an earlier filed joint return) while the other has contributed less than the maximum deductible, no transfer of deduction limit is permitted between the spouses.

6. A head of household follows the single taxpayer rules for reductions in IRA deductible limits.

7. Qualifying widowers or widows follow the married filing joint taxpayer rules for reductions in IRA deductible limits.

8. A Section 501(c)(18) plan is considered an employer plan if the taxpayer made deductible contributions during the year. Such a plan, a special type of tax-exempt trust, must have been (a) created before June 25, 1959, and (b) funded only by employee contributions. The deduction limit is reduced by any contributions to such a plan that the taxpayer made during the year.

Nondeductible IRA contributions are always reported on one's income tax return by filing Form 8606 (Nondeductible IRAs). By not filing Form 8606, the IRS will not have any record of contributions made to one's IRA that have been already taxed (because nondeductible IRA contributions have already been taxed, they will not be taxed again upon withdrawal from the IRA). For those years in which Form 8606 was not filed, it can be filed by itself. Unfortunately, there is a penalty ($50) for every year it was not filed.

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Why would an individual want to make a nondeductible IRA contribution? After all, are there any benefits if one is unable to deduct his or her contributions and get immediate tax relief (similar to TSP contributions)? The answer: tax-deferred growth in the IRA earnings – only the earnings (and not the contributions) will be taxed upon withdrawal. Also, for many individuals whose MAGI exceed maximum amounts (see below) Roth IRA contributions are not possible. *Therefore, for some individuals a nondeductible, traditional IRA is the only choice.*

A Roth IRA (sometimes referred to as a "back-ended" IRA because its tax benefits occur at the time of distribution rather than at the time of contribution) became available to taxpayers in 1998. Unlike contributions to a traditional IRA, contributions to a Roth IRA are never tax deductible. Qualified distributions are free entirely of federal income tax. Qualified individuals may convert a traditional IRA to a Roth IRA.

Contrary to what many individuals believe, the Roth IRA does not replace the nondeductible IRA. However, many individuals who make nondeductible IRA contributions are typically those with incomes above limits for Roth IRA contributions. Therefore, the Roth IRA will effectively replace the nondeductible IRA for those individuals eligible for a Roth IRA. This is because the Roth IRA generally provides better tax advantages than the nondeductible IRA.

In order to establish and make annual contributions to a Roth IRA, an individual or annuitant must have MAGI below certain limits and have an earned income, or married to someone with earned income. Failure to fully meet either requirement could lessen or eliminate an individual's ability to make a Roth IRA contribution.

MAGI for determining eligibility to make a Roth IRA contribution is an individual's AGI from his or her federal income tax return with certain modifications. For most individuals, MAGI will be the same as their AGI. MAGI for a Roth IRA is AGI, with the following items added back:

- Income from U.S. savings bonds used to pay for higher education (shown on IRS Form 8815);
- Foreign earned-income exclusion;
- Foreign housing exclusion or deduction;
- Traditional IRA deduction;
- Tuition and fees deduction; and
- Student loan interest deduction.

The MAGI limits for making a Roth IRA contribution are shown below in Table 3.

Table 3 - Roth IRA Income Contribution Limits (for 2020)

MAGI	Single, Head of Household	Married Filing Jointly	Married Filing Separately
Less than $10,000	Full Contribution	Full Contribution	Partial Contribution
$10,001-104,000	Full Contribution	Full Contribution	No Contribution
$104,001-124,000	Full Contribution	Full Contribution	No Contribution
$124,001 – 139,000	Partial Contribution	Full Contribution	No Contribution
$139,001 - $196,000	No Contribution	Full Contribution	No Contribution
$196,001 - $206,000	No Contribution	Partial Contribution	No Contribution
Greater than $206,000	No Contribution	No Contribution	No Contribution

The following example illustrates how an individual may or may not be eligible to contribute to a Roth IRA.

Example 2. Joe, a single federal employee, has MAGI of $80,000 for the year 2020. Joe has earned income of $75,000, and investment income of $5,000. Since Joe's MAGI is less than $124,000, he can make up to a $6,0000 contribution to a Roth IRA for the year 2020 (If Joe were over the age of 50, he could contribute an additional $1,000 to his Roth IRA for 2020).

Example 3. Peter is married and files a joint return with his wife Elizabeth, a federal employee. Peter and Elizabeth's MAGI for 2020 is $210,000. Because their MAGI exceeds the $206,000 limit for couples filing jointly, neither Peter nor Elizabeth may make a Roth IRA contribution for 2020.

Example 4. Jean works as an air traffic controller for the FAA. Her husband Joseph works as a computer programmer for the Department of Defense. For 2020, Jean's and Joseph's MAGI (they file jointly on their income taxes) are $199,000. The couple falls within the phase-out range and must calculate the amount they are eligible for contributing to a Roth IRA (see below).

If an individual's MAGI is within the "phase-out" range (partial contribution range), the individual must perform a calculation to determine the maximum contribution amount. The calculation proportionately reduces the amount of the contribution over the phase-out range. For example**,** if an individual's income falls exactly at the midpoint of the appropriate range (single/ head of household - $131,500, married filing jointly - $201,000), he or she would be entitled to half of a full Roth IRA contribution, or a $3,000 contribution for the year 2020**.** The IRS' method for calculating the contribution amount is presented below.

Note the following when performing these calculations: (1) Minimum $200 contribution. An individual is allowed to contribute $200 to a Roth IRA if the result from the partial contribution's calculation is more than $0 but less than $200; (2) Rounding up to the nearest $10. An individual is allowed to round the contribution up to the next highest $10 increment when using the calculation below to determine one's contribution amount to a Roth IRA.

Table 4. IRS Partial Roth IRA Contribution Formula for 2020

If your filing status is . . .	And your MAGI is between:
Married, filing a joint return	$196,000 but less than $206,000
Married, filing separately, and lived with your spouse during the year	$0 and $10,000
Single, head of household, or married filing separately and you did not live with your at any time during the year	$124,000 but less than $139,000

If one's MAGI is within the phaseout range for their filing status from the chart above, figure your reduced contribution limit as follows:

1. Start with one's MAGI.
2. Subtract from the amount on line 1:

    a. $196,00 if filing a joint return;
    b. $0 if married filing a separate return and you lived with your spouse at any time during the year; or
    c. $124,000 for all other individuals.

3. Divide the result on line 2 by $15,000 ($10,000 if filing a joint return or if married, filing a separate return).
4. Multiply the contribution limit (before reduction by this adjustment but after reduction for any contributions to traditional IRAs) by the result on line 3.

5. Subtract the result on line 4 from one's contribution limit before this reduction. The result is one's reduced contribution limit. Round up reduced contribution limit up to the nearest $10. If one's reduced contribution limit is more than $0 but less than $200, increase the limit to $200.

Example 5**.** Joseph **is** a single federal employee with taxable wages of $125,000. Joe wants to make the maximum allowable contribution to his Roth IRA for 2020. His MAGI for 2020 is $127,000. Joe has not contributed to any traditional IRA, so that his contribution limit before the MAGI reduction is $6,000. Joe figures his reduced Roth IRA contribution of $4,800 as follows:

1. MAGI = $127,000
2. $127,000 - $124,000 = $3,000
3. $3,000/$15,000 = 0.200
4. $6,000 (contribution limit before adjustment) x 0.2000 =$1,200
5. $6,000 - $1,200 = $4,800.

[See IRS Pub 590**-**A, Contributions to *Individual Retirement Arrangements*].

Which Type of IRA - Traditional or Roth - is Better?

How does an individual decide which IRA is better for him or her – a traditional IRA or a Roth IRA? Before answering that question, it is useful to briefly discuss some of the key differences between the Roth IRA and the traditional IRA. These differences include:

•**Tax treatment of contributions.** Contributions to a Roth IRA are never tax deductible, whereas a tax deduction may be allowed for a traditional IRA contribution.

• **Taxation of distributions.** Distributions from a Roth IRA meeting certain qualification requirements are free from federal income taxes, whereas distributions from a traditional IRA are subject to federal income taxes.

• **Eligibility.** The eligibility rules for contributions are different for a Roth IRA and a deductible traditional IRA.

• **Access to funds.** Assets in a Roth IRA are generally more accessible to the IRA owner than are assets in a traditional IRA.

• **Required minimum distributions.** The Roth IRA is not subject to age 70.5 required minimum distribution rules that apply to a traditional IRA.

• **Movement of assets between different types of plans.** The rules for rollovers and transfers from different types of retirement plans to a Roth IRA and to a traditional IRA are different. A Roth IRA may not receive assets from qualified plans.

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In another related question, how does an individual determine whether a Roth IRA or a traditional IRA belongs with his or her retirement plan? In other words, which offers the best tax advantages? Which tax shelter will help build the biggest retirement nest egg?

For newer employees, many of whose average incomes are lower than older employee incomes, the question is somewhat more challenging. These workers may be eligible to deduct their contribution to a traditional deductible IRA.

First, if an employee's income is too high to deduct the traditional IRA contribution, then the Roth IRA is a great addition to an employee's retirement savings arsenal. Even without deducting the contributions, the Roth IRA has clear advantages - primarily the fact that there is no mandatory withdrawal schedule to worry about, and that money in a Roth IRA can also go to an heir tax-free.

What about the financial advantage of getting tax-free (the Roth IRA) versus taxable, (traditional IRA) withdrawals? In reality, there is no guarantee that in the future the Roth IRA will be better than the traditional IRA. One almost needs a crystal ball (and a good financial calculator) to know whether it makes sense to give up tax deduction today for tax-free income tomorrow.

The answer is partially dependent on the issue of one's tax bracket at the time of contribution versus one's tax bracket at retirement. At retirement, if an individual is in a lower tax bracket, the traditional, deductible IRA is a better choice; if the worker is in a higher tax bracket at retirement, then the Roth IRA is a better choice. For most individuals who are ineligible to deduct their IRA contribution due to income restrictions, the Roth IRA is probably the best choice.

Conversion from a Traditional IRA to a Roth IRA

Individuals are also given the opportunity to convert traditional (taxable) IRAs into Roth IRAs and achieve long-term savings. For many workers, the tax advantages of the Roth IRA are significantly greater than those obtained through a traditional IRA. If such a conversion was performed in 1998, an individual had the option of spreading the amount included in gross income (and subject to income taxes) over a four-year period beginning with that year. After 1998, the entire amount of gross income that is triggered by the conversion of a traditional IRA, to a Roth IRA is included in the taxpayer's income in the year of the conversion. Conversions and recharacterizations are discussed in more detail in Chapter 9.

Whether conversion of a traditional IRA to a Roth IRA makes sense for an individual depends on a variety of factors, including the employee's age, current and future income tax brackets, need for the funds, estate planning objectives, and ability to pay the accelerated income taxes that will become due.

A brief review of the rules for converting a traditional IRA to a Roth IRA is now presented. Under a law that took effect Jan. 1, 2010, any individual - no matter their income, age, or tax filing status - can convert a traditional IRA to a Roth IRA. Before Jan. 1, 2010, only

individuals with modified adjusted gross income less $100,000 and who did not file as married filing separately could convert a traditional IRA to a Roth IRA.

A nondeductible IRA may be converted to a Roth IRA. In such an event, only the portion of the IRA in excess of individual's contribution(s) would be included as a result of the conversion.

There is no requirement regarding how long funds must be held in a traditional IRA before being converted to a Roth IRA. In addition, there is no minimum or maximum age for being able to convert to a Roth IRA.

For individuals who are eligible to contribute to a Roth IRA, it probably makes little sense to convert a traditional IRA to a Roth IRA. But for those individuals whose MAGI are too high and are therefore ineligible to contribute to a Roth IRA, conversion may make sense. But before converting, the traditional IRA owner should have sufficient liquid funds available to pay the federal and state income taxes due on conversion.

Chapter 3. Some of the Specific Attractions of IRAs

For individuals, IRAs (including traditional and Roth IRAs) can provide some or all of the following attractions:

- A convenient depository and a disciplined method for annual savings.
- A tax deduction (for some employees) in the case of some traditional IRA contributions.
- A way to achieve tax-deferred growth of all assets.
- A supplemental source of retirement income.
- A source of emergency funds.
- A source of funds for higher education.
- A source of funds for a first home.
- A vehicle for pursuing several investment options.
- A way to retain transferability.
- An opportunity to maintain individual control of retirement funds or other funds.
- Another instrument for completing an individual's financial plan.

The key to the savings aspects of IRAs are the tax benefits of IRAs – in particular the tax-deferred (and in the case of Roth IRAs, the tax-free growth). An individual may be eligible for an up-front deduction for making the contribution. It must be remembered, however, that all three types of IRAs (traditional-deductible and nondeductible, and Roth IRAs) contain penalties if assets are withdrawn prematurely or for nonqualified reasons – in most cases a 10 percent penalty. The penalty could cancel out any tax benefit received from the IRA.

Another use for a traditional IRA is as a depository for accumulated retirement money from qualified retirement plans including the Thrift Savings Plan that most Federal employees participate in. Since the passage of the Tax Simplification Act of 1986, holding rollover assets from qualified retirement plans has been one of the primary uses of the traditional IRA.

One of the more important reasons that employees (usually, former employees) want to remove assets from a qualified retirement plan is to have more direct control over the investment and distribution of those assets – yet they do not want to incur the full tax consequences of taking

the assets directly. A transfer to a traditional IRA is useful for maintaining a retirement fund that has already been developed under another plan.

By requesting a direct "trustee-to-trustee" of assets from a qualified retirement plan to a traditional IRA, an individual will avoid the 20 percent mandatory federal income tax withholding. Here is an example of such a request.

Example 1. Peter, age 56, retires from federal service with $150,000 in his traditional TSP account. Peter would like to have more investment control over his retirement, as well as more fund choices. He therefore requests his Thrift Savings Service Office via Form TSP-70 to directly transfer his entire traditional TSP balance to his traditional IRA that is maintained by the XYZ Company as the custodian for his IRA.

Under a law that took effect Jan, 1, 2010, funds from a qualified retirement plan - this includes a 401(k) plan, a 403(b) plan and the TSP - may be transferred to a Roth IRA. This transfer can be done once an employee retires. For example, a TSP account owner may request a one-time rollover of part of their traditional TSP account to an existing Roth IRA. But traditional TSP participants should be aware that a traditional TSP transfer to a Roth IRA is a taxable event. As such, the TSP participant who requests such a transfer will pay full federal and state income taxes on the amount transferred.

Both a Roth IRA and a traditional, nondeductible IRA may also be useful as a depository for emergency funds. Both types of IRAs can serve as a source for emergency funds because an IRA owner can always make a penalty- and tax-free distribution of his or her contributions amounts at any time and for any reason. However, earnings must remain in the account in order to avoid taxes and penalties.

There is also no limit as to the number of "trustee-to-trustee" transfers (qualified retirement plan to traditional IRA, traditional IRA to traditional IRA, traditional rollover (or conduit) IRA to a qualified retirement plan that an individual may request. On the other hand, a rollover (in which the individual initially receives the qualified money and has 60 days from the day of receipt to deposit the funds into another qualified plan or into an IRA) may be accomplished only once a year. However, each IRA has the once-a-year opportunity- and an individual may have as many separate IRAs as he or she wishes to create. The rules limiting rollovers to one annually apply separately to traditional and to Roth IRAs. The one-year period starts on the day that the amount is received from the IRA making the distribution, as the following example illustrates:

Example 2. Bob directs the TSP to directly transfer his entire TSP account to a traditional IRA-1 Shortly thereafter, Bob rolls over his traditional IRA-1to a new traditional IRA-2 within the 60 day roll over period. He is not allowed to perform any more rollovers for the next 12 months, for this or any other IRAs that he may possesses.

Under a law that took effect Jan. 1, 2015, an IRA owner is allowed to do only one rollover per 12 months. This includes rollovers of Traditional and Roth IRAs. *But there is no limit of direct transfers from one IRA to another IRA.*

IRAs and Federal Employees

Finally, the traditional and Roth IRA provide powerful ways to help complete an individual's financial plan. For the wealthy, an individual financial plan may involve only the need for an emergency fund on a tax-advantaged basis. This could be accomplished both through a traditional and a Roth IRA. IRAs can be used to fill any gaps in expected cash flow. For example, a federal employee who retires at age 60 (under FERS) may need additional income to supplement his TSP income until he or she reaches age 62, at which time Social Security payments will begin. Also, as will be discussed in Chapter 10, IRAs may serve as tools to save for a child's higher education expenses and for first-time home buyers.

Chapter 4. Qualifications for Contributing to an IRA

In order to be eligible to be eligible to contribute to any type if IRA, an individual must have earned income. For most federal employees, earned income means wages (compensation) as shown on an employee's W-2. This is in contrast to investment income (interest, dividends, or capital gains) or pension income (distributions from the Thrift Savings Plan or civil service retirement).

Earned income also includes tips, commissions, self-employment income and nontaxable combat pay. Also, earned income includes a lump sum payout of unused annual leave hours. This has implications for federal employees who retire in December and request a lump sum payout of accrued leave that they will the next month in January. The following example illustrates:

Example. Kevin retired from federal service in December 2019. In January 2020, Kevin received a lump sum payment of his accrued unused annual leave of 240 hours. Because Kevin's annual leave payment check is dated in January 2020, the money received by Kevin is considered as taxable wages for 2020. Kevin will receive a W-2 from the Office of Personnel Management in January 2021 showing the annual leave lump sum payment. Furthermore, even if Kevin (or spouse, if married) does not work during 2020, he (and spouse if married) could contribute to an IRA based on his annual leave payment during 2020.

Other forms of earned income for purposes of IRA contributions include alimony and separate maintenance payments. Thus, a divorced taxpayer receiving alimony during 2020 may contribute as much as $6,000 ($7,000 if over age 50) even if he or she is not working. Under the SECURE Act that became law in December 2019, there is no longer an age limit as far as contributing to a traditional IRA (until the passage of the SECURE Act, starting in the year an individual became 70.5, the individual could no longer contribute to a traditional IRA (even if the individual or the individual's spouse had earned income); for a Roth IRA, there has never been an age limitation with respect to contributing to a Roth IRA.

With married couples, each spouse can contribute to his or her own IRA even if only one spouse is working. Therefore, an individual who retires but whose spouse continues to work could continue to contribute to his or her IRA based on the spouse's earned income. The retiree can make the contribution to the same IRA in which he or she contributed in previous years based on "earned income". Now the IRA becomes a "spousal IRA", as opposed to a "contributory" IRA.

Chapter 5. Adopting (Opening) an IRA

To adopt an IRA one must complete the documentation legally required to make an IRA contribution. “Establishing” is used synonymously for “adopting” in the discussion of IRAs. An IRA (traditional or Roth) must be adopted no later than the tax filing date (with no extensions) for an individual wishing to adopt an IRA for the taxable year for what the plan is made effective.

Example 1. George, an individual working for a private company, is a calendar year taxpayer. To adopt an IRA for 2020, George must adopt the IRA later than April 15, 2021 (it makes no difference whether or not George obtains an extension for filing his 2020 income tax return). All of George’s IRA contributions for 2020 must be made no later than April 15, 2021.

Note that in order to adopt or to establish an IRA, one does not have to actually fund an IRA. However, most individuals do in fact adopt and fund their IRAs simultaneously. Also, an IRA trustee or custodian is required to provide a disclosure statement upon establishment of an IRA. If the funding of the IRA comes after the establishment, the trustee or custodian is not required to provide additional IRA disclosure.

The following institutions may sponsor IRAs: (1) Banks; (2) Brokerages; (3) Mutual Fund companies; (4) Federal Credit Unions; and (5) Life Insurance companies. While life insurance companies may sponsor IRAs, they may not offer life insurance or endowment contracts as investment options.

There is no legal limit as to the number of IRAs that may be established by an individual. However, there is an annual maximum contribution amount that applies in the aggregate to all IRAs (including traditional and Roth IRA’s). Consider the following example.

Example 2. Sally, age 43, currently owns five IRAs. Three of the IRAs are traditional, nondeductible IRAs that were established in 2010, 2011 and 2012. The other two IRAs are Roth IRA’s established in 1998 and 2000. Sally wants to keep funding all of these IRAs because they are invested in different types of mutual funds, providing diversification to Sally’s retirement portfolio. For 2020**,** Sally can contribute $1,200 to each of her IRAs, a total of $6,000 (the maximum contribution amount to IRAs during 2020).

Example 3. Same facts as Example 2, except that Sally is age 53. In that case, Sally is entitled to contribute an additional $1,000 to her IRAs for 2020. Sally decides to contribute an additional $200 to each of her five IRAs. Sally therefore contributes a total of $1,400 to each of her IRAs for 2020.

In practice, many trustees and custodians impose minimum dollar limits and charge a custodial fee for each IRA. These custodial fees typically range in price for $10 to $100, and therefore discourage individuals from opening multiple IRAs.

In establishing an IRA through a written document, the document must show that the account meets all of the following requirements:

• The trustee or custodian must be a bank, a federally insured credit union, a savings and loan association, or an entity approved by the IRS to act as trustee or custodian.

• For 2020, the trustee or custodian generally cannot accept contributions of more than $6,000 ($7,000 if the IRA owner is 50 years or older as of Dec. 31, **2020**).

• Contributions must be in checks/cash.

• The IRA owner must have a non-forfeitable right to the IRA at all times.

• Money in the IRA cannot be used to buy a life insurance policy.

• Assets in the IRA cannot be combined with other property, except in a common trust fund or common investment fund.

• For traditional (but not a Roth) IRA, distributions from the IRA must begin by April 1 of the year following the year in which the IRA owner reaches age 70.5.

The trustee or issuer (sometimes called the sponsor of a traditional IRA owner) must furnish a disclosure statement to the IRA owner at least 7 days before the IRA is set up. The disclosure statement must explain (in simple terms) how and when the IRA may be revoked including the name, address and telephone number of the person to receive the notice of cancellation. If the IRA is revoked within the revocation period, the sponsor must return in full the entire amount paid.

IRS Forms 5305 and 5305-A are approved IRS documents that are used in establishing an IRA.

Roth IRAs are adopted in a fashion similar to that for traditional IRAs. The IRA trustee (or custodian) must obtain the potential Roth IRA owner's Social Security number or individual taxpayer identification number when a Roth IRA is being established. Both the Roth IRA owner and the trustee (or custodian) must sign the Roth IRA agreement. A spouse's signature may also be necessary if the Roth IRA owner lives in a community property state and names someone as beneficiary other than the owner's spouse.

Any financial institution authorized to accept traditional IRA contributions will automatically be approved to accept Roth IRA contributions. Also, there is no limit on the number of Roth IRAs an individual may establish; the overall combined annual contributions to multiple Roth IRA's is limited to the same annual maximum as for a single IRA.

Chapter 6. Contributions to Traditional and Roth IRAs

Individuals who have IRAs must comply with the following rules, applicable to both traditional and Roth IRAs.

- **Contribution amount.** The maximum contribution is the lesser of an individual's earned income or the maximum dollar amount ($6,000 in 2020). In addition, individuals age 50 and older have higher limits - $1,000 per year.

- **Contribution deadline.** Contributions must be made by the IRA owner's tax filing due date, not including extensions.

- **Spousal IRA rules.** Similar rules apply regarding the ability to make contributions on behalf of lesser-compensated spouses.

There are also some contributions rules that are unique to either the traditional IRA or the Roth IRA:

- **Deductibility rules.** Roth IRA contributions are never deductible.

- **Age limitations.** Workers who have attained age 70.5 by the end of the taxable year for which the contribution is made are not eligible to make traditional IRA contributions; this limitation does not apply to the Roth IRA.

- **Income limits.** The Roth IRA rules place maximum income limits on eligibility; the traditional IRA rules do not.

- **Rollover rules.** A traditional qualified retirement plan - for example, a 401(k) or the TSP - may be rolled over to a traditional "rollover" IRA. If this is a direct rollover or a direct transfer, then the rollover or transfer is not a taxable event. But a rollover or transfer of a traditional qualified retirement plan to a Roth IRA is a taxable event. As such, the qualified retirement plan owner must pay federal and state income taxes on the amount rolled over or transferred. A Roth retirement plan - for example, a Roth 401(k) plan, Roth TSP, Roth 403 (b) plan, or a Roth 457 plan - may be transferred tax-free to a Roth "rollover" IRA. More information on rollover rules is presented in Chapter 7.

IRAs and Federal Employees

An individual may contribute to both a traditional IRA and a Roth IRA in the same tax year; for example, in 2020 the total contribution amount for both IRAs is the lesser of $6,000 (or $7,000 if employee is over age 50) or the employee's earned income.

Creating multiple IRAs will not increase an individual's annual contribution limit. For example, if an individual has 10 IRAs, then they could contribute $550 to each IRA for **2020,** or a total contribution of $6,000. But if an individual contributes less than the maximum allowed in a given year is made in a taxable year, the difference may not be carried forward to another year.

IRA owners should be aware that the IRS imposes a penalty for IRA owners who contribute more than the maximum allowed in a given year. The penalty is equal to 6 percent of the excess amount contributed. The only way to avoid the penalty is for the IRA owner to withdraw the excess contribution no later than the tax filing deadline of April 15th . Note that the penalty is imposed each year, as the following example illustrates:

Example 1. Julie, age 44, contributes $7,000 to her Roth IRA during 2019. If Julie does not withdraw the excess IRA contribution of $7,000 less $6,000 or $1,000 by April 15, 2020, then Julie will be subject to an excess contribution penalty equal to 6 percent of $1,000 or $60 for the year 2019.

Contribution deadlines

Contributions to a traditional and Roth IRA must be made before the filing date for an individual's income tax return (not including extensions). The contributions are considered to have been made on the last day of the tax year for which the return is being filed.

If an individual makes an IRA contribution between January 1 and April 15 (April 15, 2020 for 2019), then the individual must instruct his or her IRA trustee or custodian about how to report such a contribution to the IRS. That is, if the individual wants to an IRA deduction for the previous year, the trustee, custodian or sponsor of the IRA must be so advised. Otherwise, the sponsor is required to report the contribution as applying to the current year.

However, it is possible that if an IRA contribution is received after the tax filing due date, then it is in "timely mode". For example, the IRS recently ruled that a bank could have accepted as timely a mail payment that was postmarked April 12 even though it was not received until April 16. As such, the US Postal Service is treated as an agent, and its cancellation mark is accepted as evidence under general contract law. The IRS has further ruled that the date of the postal service postmark is deemed to be the date of payment.

Planning Point

It would be prudent, even if not legally required, for an individual to diligently follow up with the IRA addressee if the normal confirmation of an IRA contribution is not provided within a reasonable time.

An IRA contribution may nevertheless be made after the tax return that reports the contribution has been filed, as illustrated in the following example:

Example 2. Sarah filed her 2019 income tax return on March 1, 2020. On her federal and state tax returns. Sarah shows a deductible $1,000 IRA contribution made for tax year 2019. Even though Sarah has filed her returns for 2019, Sarah had until April 15, 2020 to make her $1,000 contribution for tax year 2019.

If a taxpayer makes an IRA contribution (any type) after the taxpayer's tax filing date and the tax returns has already been filed, then the taxpayer has two choices:

(1) The taxpayers may file an amended return reversing the deductions (if a deductible IRA contribution) and pay the tax; or

(2) The taxpayer may file an amended return indicating that the contribution is being made in the current year on a tax return that is expected to be filed in the following year.

Penalties may be imposed, depending on how prompt corrective measures are made.

It should be noted that there is no requirement that IRA contributions be continued annually. Also, there is no requirement that the same IRA be used for all contributions. An individual may choose to establish new IRAs for subsequent contributions.

<u>Spousal IRA's</u>

Many individuals who are married can take advantage of the spousal IRA rules for either a traditional or a Roth IRA.

In order to take advantage of the spousal IRA rules, a couple must meet the following three requirements:

- They must be legally married;
- They must file a joint federal income tax return; and
- The "receiving" spouse must have less compensation than the spouse making the contribution (or no compensation).

Consider the following two examples:

Example 3. Roger, age 42 and a federal employee, is married to Sarah, age 35 who is currently not working. Roger and Sarah's MAGI for 2020 is $80,000. Roger can contribute a maximum $6,000 to his Roth IRA for 2020, and Roger can also contribute $6,000 to Sarah's spousal Roth IRA.

Example 4. William, age 73, is married to Barbara, age 71. William is a retired federal employee while Barbara is currently working for the federal government and intends to retire in 2020. Their MAGI is expected to $75,000 in 2020. Their MAGI is not expected to rise above $85,000 over the next few years. Assuming Barbara continues to work, she can contribute the maximum allowed amount ($7,000 during 2020) to her Roth IRA and to William's spousal Roth IRA – even though William is retired and over age 70.5. *Note that under the recently passed SECURE Act in December 2019, this same type of contribution could have been made to a traditional IRA.*

For 2020, the total combined contribution a couple may make each year to both their Roth IRAs and traditional IRAs is the lesser of $12,000 ($14,000, if both spouses are over age 50) or the couple's combined compensation (earned income) for 2020. The couple may divide their total contribution in any matter they choose as long as neither spouse contributes more than $6,000 /$7,000 in any type of IRA or combination of IRA's during 2020.

Finally, a spousal IRA is treated in the same way as a regular IRA, with the 'earning" spouse having no control over the spousal IRA. The spousal IRA is under the same rules as a non-spousal IRA.

The worksheet presented in the Appendix allows traditional IRA owners to keep track of their contributions to their traditional IRAs for calendar year 2020 as well as keep track of their basis in nondeductible traditional IRAs as shown on IRS Form 8606.

Chapter 7. IRA and Retirement Account Rollovers or Transfers

A rollover is in fact a method for moving an individual's IRA or qualified retirement plan assets from a financial institution to a traditional IRA or, in some cases, from one type of retirement plan to another. A rollover generally moves assets without changing the character of the account and, if done properly, will be tax- and penalty-free.

There are several possibilities of performing rollovers, including from one IRA to another, from a qualified retirement account (such as a 401(k) plan or the Thrift Savings Plan) into an IRA, and from an IRA to a qualified retirement account (such as a 401(k) plan or the Thrift Savings Plan). Here are the most common types of rollovers that federal employees may perform:

- **Traditional IRA to Traditional IRA.** This type of rollover allows for the movement of assets from one traditional IRA to another.

- **Roth IRA to Roth IRA.** This type of rollover allows for the movement of assets from one Roth IRA to a new Roth IRA. It generally follows the same rules as those for a traditional IRA rollover.

- **Qualified Retirement Plan (including the TSP) to a Traditional IRA or to a Roth IRA.** Assets from a qualified retirement plan may usually be rolled over or transferred into a traditional IRA or to a Roth IRA. Note: If the rollover is not a direct rollover (see below), the distribution plan will generally impose Federal income tax withholding at a rate of 20 percent on the amount of the distribution that is eligible for rollover. Note that a qualified retirement does not include the CSRS or FERS annuities.

- **Rollover IRA to a Qualified Retirement Plan.** Assets in a "rollover" traditional IRA consisting of previously rolled over qualified retirement plan assets may be rolled back into the qualified retirement plan.

It is useful to explain in more detail the difference between a rollover, a direct rollover and a transfer. Individuals may move assets between various types of retirement plans by different means, each having vastly different reporting and tax consequences. Here's a brief description of the three methods, together with any possible tax consequences.

- **Rollover.** With a rollover, an individual requests and receives a distribution from his or her traditional IRA (or a qualified retirement plan) and transfers the assets to another traditional IRA or to another qualified retirement plan.

●**Direct Rollover.** With a direct rollover, assets are moved directly from an employer's qualified retirement plan into a traditional IRA or into another qualified retirement plan.

●**Transfer.** A transfer occurs when qualified retirement assets or IRA assets are moved directly from one trustee or custodian to another trustee or custodian.

From a practical standpoint, when an IRA owner is not satisfied with the investment performance of their IRA, the IRA owner would desire to rollover assets of that IRA to another IRA of the same type. Also, some IRA owners also carry out rollovers because they want to use their funds outside of the IRA during the 60-day period (explained below) allowed to complete a rollover.

Rules for Rollovers from a Traditional IRA to a Traditional IRA

In general, the individual IRA owner must complete a rollover from a traditional IRA within 60 days of receipt of the funds, *and the individual is allowed only one such rollover* ***per*** *12-month period (12-month rule), no matter how many IRAs (and which type) are owned.*

Consider the following examples:

Example 1. Andrea needs to take $40,000 out of her IRA in response to a family financial emergency. She does this on February 1, 2020. On February 15, 2020, Andrea discovers that the emergency was not as bad as she had imagined, and therefore she rolls the $40,000 back into her traditional IRA. Since she is within the 60 days of receiving the $40,000 of IRA assets, (period ending April 1, 2020), she will therefore be not subject to any tax on the $40,000 (temporary) withdrawal.

Example 2. Same facts as in Example1, except that Andrea decides to roll back only $30,000 of the $40,000 originally withdrawn. She will be taxed on the $10,000 not rolled back, and if she is younger than age 59.5, she will be subject to a 10% "early withdrawal" IRS penalty tax.

The IRS interprets the 60-day rule "strictly". In fact, exceptions to the rule that a rollover be completed with 60 days are rarely granted. However, effective Jan. 1, 2002, the IRS has had the authority to extend the 60-day rollover period in cases where not doing so would be "against equity or conscience" (e.g., a casualty, disaster, or other event beyond the control of an individual). Also, when the last day of the 60-day period for completion of a rollover falls on a holiday or a weekend, the deadline is extended another day that is not a Saturday, a Sunday, or a legal holiday.

Chapter 8. Getting an IRA "Up and Running"

There are unlimited choices of how and where to invest IRA money – whether it is a traditional IRA or a Roth IRA, individuals have lots of choices.

An individual can go to a bank, to a savings and loan, or to a credit union. An individual can call a mutual fund family. Or an individual can take control himself or herself through a "self-directed" account, managed individually and run through a brokerage firm.

The next choice after deciding who will be the sponsor or sponsors of your IRA is to decide specifically how to invest the IRA money – blue chip stocks, foreign stocks, corporate bonds, certificates of deposit, etc.

Of course, the deployment strategy that one selects will depend on one's age, size of portfolio, tolerance for risk, as well as one's investments in other retirement plans.

There is no limit as to how many IRA accounts an individual can own as long as one's total contribution does not exceed the annual contribution limits. But keep in mind the maintenance and brokerage fees that may have to be paid. The more IRAs one has, the more fees that one may have to pay for IRA maintenance.

Whatever one decides with respect to investing an IRA, one should open an IRA and contribute to it as early in their working years as possible. Furthermore, even though IRA owners have until April 15th of the following year for funding the current year IRA(s), it pays to make IRA contribution as early in the year as possible, as the following table illustrates:

Table 4. $3,000 per Year IRA Contribution Earning at 5%* Annualized Rate of Return

Number of Years From the Beginning of the First Year	Contribution Made Jan. 1	Contribution Made Dec. 31	Increase in Amount By Investing at Year Beginning
5	$17,406	$16,577	$829
10	$39,620	$37,734	$1,886
15	$67,972	$64,736	$3,226
20	$104,158	$99,198	$4,960
25	$150,340	$143,181	$7,159
30	$209,282	$199,317	$9,965
35	$284,509	$270,961	$13,548
40	$380,519	$362,399	$18,120

**Past Performance is No Guarantee of Future Results*

Table 5. $3,000 per Year IRA Contribution Accumulated at 10%* Annualized Rate of Return

Number of Years From the Beginning of the First Year	Contribution Made Jan. 1	Contribution Made Dec. 31	Increase in Amount by Investing at Year Beginning
5	$20,147	$18,315	$1,832
10	$52,593	$47,812	$4,781
15	$104,844	$95,317	$9,532
20	$189,007	$171,825	$17,182
25	$324,545	$295,041	$29,504
30	$542,830	$493,482	$49,348
35	$894,380	$813,073	$81,307
40	$1,460,555	$1,327,778	$132,777

**Past Performance is No Guarantee of Future Results*

Note the large differences between investing one's IRA consistently in the beginning versus waiting until the end of the year. The differences become quite profound with assumed higher rates of investment return and for longer period of time (more than 20 years).

In short, it makes sense to start one's IRA as early in one's working career as possible and to consistently contribute to the IRA as much as possible. Consider this: A 22-year-old federal employee invests $3,000 a year for 40 years in a Roth IRA earning an assumed annualized return of 10 percent (past performance is no guarantee of future performance) could have $1.5 million in their Roth IRA by the time he or she leaves retires from federal service at age 62. And there is no requirement to withdraw any funds from a Roth IRA (unlike the traditional IRA, which minimum required distribution must begin at age 70.5 for individuals born before July 1, 1949, age 72 for individuals born after June 30, 1949). This means that the funds can continue to grow tax-free. For example, assuming an average annualized 10 percent rate of return, the $1,460,555 will grow to $3,740,491 in 10 years and to $9,654,059 in 20 years.

Chapter 9. Distributions from IRAs

For the most part, an IRA owner can request a distribution from a traditional (or Roth, in the case of earnings) before the IRA owner becomes age 59.5; however, the IRA owner may be subject to a 10% penalty for premature distribution.

However, there are some exceptions to this penalty, including:

- Becoming permanently disabled.
- Using the IRA money to pay medical bills that exceed 10 percent of one's adjusted gross income (AGI).
- Using the money to pay for health insurance premiums during an extensive period of unemployment.
- Using up to $10,000 to help pay for, or build a first home for one's self, spouse, children, grandchildren – even parents. The $10,000 is a lifetime limit – not an annual one.
- Using the money to pay higher-education expenses for one's self, spouse, child, or a grandchild. Qualified expenses include tuition fees, and room and board for post-secondary education, including graduate work.
- Take the money in equal annual amounts, designed to exhaust the account during the course of your life expectancy (as estimated by the IRS). There are also two methods ("amortization" and "annuitization") that will result in a larger payout than the payments computed using life expectancy. Rules regarding making penalty-free IRA withdrawals before age 59.5 are spelled out in Internal Revenue Code Section 72(t).

Note that under the last exception, one may begin withdrawals at any time. However, in order to avoid the 10 percent penalty, one must continue with the method chosen (life expectancy, amortization, or annuitization) for the <u>longer</u> of five consecutive years, or until one becomes age 59.5. Otherwise, one will be subject to a 10% penalty for the entire period retroactive to the first distribution.

A traditional IRA (deductible or nondeductible) owner *born before July 1, 1949* can make penalty-free (with respect to the IRS) withdrawals after age 59.5 but is not required to make any withdrawals until age 70.5. In particular, for traditional (but not Roth) IRA owners the required beginning date (RBD) for commencing distributions is April 1 of the calendar year

following the calendar year in which the owner attains age 70.5. For example, an IRA owner who attains age 70 on Feb. 1, 2019 (and thus became 70.5 on Aug. 1, 2019) has his or her RBD on Apr. 1, 2020.

Under the SECURE Act passed in December 2019, the RMD age was raised from age 70.5 to age 72 but only for individuals born after June 30, 1949.

Ordinarily, the individual who owns an IRA continues to be the owner until death and thus is the recipient of distributions from the IRA. After the death of the IRA owner, the named beneficiaries are permitted to receive distributions pursuant to the terms of the IRA plan document.

On Jan. 11, 2001, the IRS issued new proposed regulation regarding "minimum required distributions" (MRD) for IRA owners over age 70.5. This regulation became effective for IRA distribution beginning on or after Jan. 1, 2002. *Note that Roth IRA owners are not subject to the MRD rules.*

The IRS imposes a 50 percent penalty (50 percent of the amount of the MRD not withdrawn) on IRA owners who are required to make a MRD and do not. Note that the 50 penalty is imposed each year that a MRD is not performed.

The proposed regulations (that were approved and took effect in 2002) provide for a simple uniform table of life expectancy divisors (Uniform Table) that with only one exception applies to every IRA owner in calculating his or her MRD. In order to calculate the RMD, the IRA owner merely has to determine, for the year of distribution and for his or her age, the "life expectancy" value as shown in Table 9.1 (the IRS updated this table in April 2002). Also, the previous December 31 balance (fair market value) of all traditional IRAs is determined and is divided by the life expectancy value in determining the MRD.

The only exception to using the Uniform Lifetime Table is when an IRA owner's beneficiary is a spouse and the spouse is more than 10 years younger than the IRA owner. In that case, because the joint life expectancy would be longer than the life expectancy obtained under the Uniform Table, the IRS permits the use of the longer life expectancy (see IRS Publication 590, written in 2013 version which can be downloaded from **www.irs.gov**, for the most up-to-date joint life expectancy table).

Some examples help illustrate:

Example 1. Iris became age 70.5 during 2019. As of Dec. 31, 2018, the total value of Iris' two traditional IRA's was $20,000. Iris calculates her MRD for the year 2019 as follows: From Table 9 below, Iris' life expectancy is 27.4 years. Her MRD is $20,000 divided by 27.4, or $729.93. In order to avoid a penalty, Iris must request this MRD no later than Apr. 1, 2020. Note that Iris can request more than $729.93; the $729.93 is merely a minimum amount to be requested in order to avoid the IRS's MRD penalty for the year 2019.

Example 2. Same facts as in Example 1 except that Iris is married to someone who is age 57. In that case, Iris would use the joint life expectancy table from IRS Publication 590-B (2019 version) which (for a joint life expectancy of ages 70 and 57) is 29.5. Iris' 2019 MRD would then be calculated as $20,000 divided by 29.5, or $677.97.

Example 3. Same information as in Example 1 except that the MRD is for the year 2020. On Dec. 31, 2019, the total value of Iris' IRA two accounts has decreased to $18,000. At age 71, (Iris is one year older in 2020), her life expectancy from Table 1 is 26.5. Iris's 2020 MRD is therefore calculated as $18,000 divided by 26.5, or $679.25. *Iris must request this MRD no later than Dec. 31, 2020.*

Table 6. The Uniform Table (effective April 2002)

Age	*Applicable Divisor*	*Age*	*Applicable Divisor*
70	27.4	86	14.1
71	26.5	87	13.4
72	25.6	88	12.7
73	24.7	89	12.0
74	23.8	90	11.4
75	22.9	91	10.8
76	22.0	92	10.2
77	21.2	93	9.6
78	20.3	94	9.1
79	19.5	95	8.6
80	18.7	96	8.1
81	17.9	97	7.6
82	17.1	98	7.1
83	16.3	99	6.7
84	15.5	100	6.3
85	14.8	101	5.9

Planning Points for MRD's

1. The rules involving a traditional IRA's MRD affect retirees who are over age 70.5 (age 72 if born after June 30, 1949).

2. Even though an employee older than age 70.5 can contribute to a traditional IRA (as a result of the passage of the SECURE Act), the employee is still bound by the IRA MRD rules.

3. Employees or annuitants with IRAs and whose sole IRA beneficiary is a spouse more than 10 years younger than the IRA owner, will use the recalculation method for computing MRD.

Under this method, the IRA owner uses the actual age of the spouse to determine their true joint life expectancy every year under the IRS tables (see IRS Publication 590-B, 2019 version).

Upon the death of the IRA owner, the identity of the IRA owner's beneficiary is still relevant in the calculation of post-death distribution. Depending on the type of beneficiary that was designated (e.g., spouse, non-spouse or a trust) different rules apply for each type of beneficiary. In some situations, the calculation of post-death distributions also depends on whether the IRA owner died before or after his or her RBD.

For IRA owners, the primary elective and designations that must be made during his or her lifetime is the naming of an IRA beneficiary. Under the IRS new rules that took effect on 1/1/02, the beneficiary designation itself is somewhat irrelevant (except in the case of a spouse who is more than 10 years younger than IRA owner) in the calculation of the traditional IRA owner's RMD.

However, a beneficiary designation has lasting consequences after the IRA owner's death. It is therefore advisable that individuals who own IRAs to review the IRA plan documents to determine whether they are accurate. Owners of more than one IRA need to review each IRA's plan documents. An IRA owner may change his or her beneficiary designation at any point during his or her lifetime.

Elections and designations under an IRA should be executed by the IRA owner and filed with the IRA trustee (or custodian). A copy of any election or designations filed with an IRA trustee or custodian should be maintained.

Chapter 10. Conversions of Traditional IRAs and Recharacterizations

Conversion of Traditional IRAs to Roth IRAs

Since Jan. 1, 2010 , the IRS has allowed individuals to convert their traditional IRA funds (and some other untaxed IRA funds) to Roth IRA funds by paying income tax on any account balance being converted that has not already been taxed (e.g., the traditional IRA balance minus any non-deductible contributions). Originally, there were income limits that prevented high earners from performing such conversions, but those restrictions have since been lifted.

Many individuals have reasoned, therefore, that since there are no income limits to prevent high earners from making non-deductible contributions to traditional IRAs, and since anyone can convert traditional IRAs to Roth IRAs, high earners can simply contribute to a traditional IRA (with a non-deductible contribution) and convert the traditional IRA immediately to a Roth IRA, thereby legally circumventing income limitation rules and taking advantage of the Roth IRA's valuable benefits. No taxes would be owed on the conversion, they reason, since the converter would be converting the exact amount that he deposited – and on which he or she has already fully paid income taxes.

But the IRS does not allow converters to specify which dollars are being converted as they can with shares of stock being sold; for the purposes of determining taxes on conversions the IRS considers a person's non-Roth IRA money to be a single, co-mingled sum. Hence, if an individual has any funds in any non-Roth IRA accounts, it is impossible to contribute to a traditional IRA and then "convert that account" to a Roth IRA as suggested by some individuals. *Conversions must be performed on a pro-rata basis of all IRA money, not on specific dollars or accounts*.

For example: If a person has $45,000 in a rollover traditional IRA (untaxed money) and then attempts to utilize the strategy above to avoid income limitations on a Roth contribution by making a $5,000 non-deductible contribution to a traditional IRA and then converting that account to a Roth IRA, the IRS will calculate that he owes taxes on an additional $4,500 of income – since it will look at the $50,000 in total non-Roth IRA money as it were one account, and since 90% of that balance (i.e., $45,000) is untaxed he owes taxes on 90% of the conversion amount of $5,000 (i.e., $4,500). Furthermore, after paying taxes on the $4,500 the converter will need to track that he has $4,500 of already-taxed non-rollover money in his Rollover IRA account – which will not only complicate matters from an accounting perspective for years to come, but may also prevent him from rolling the money into an employer's 401(k) plan in the future

IRAs and Federal Employees

Situations in which pro-rata calculations must be done for conversions are not rare; a large percentage of today's federal employees with rather large salaries started working before Roth IRAs were available and have non-Roth IRAs as result. Many left jobs and moved 401(k) money into rollover IRAs. Others may have accumulated SEP IRAs or SIMPLE IRAs along their career paths as well.

Furthermore, the requirement for pro-rata calculations may plague not only people trying to circumvent Roth IRA income limitations, but also people seeking to convert non-deductible portions of traditional IRA account balances into Roth IRA accounts.

Depositing all of an employee's pre-taxed rollover traditional IRA or contributory traditional IRA money into their traditional TSP account prior to making a traditional IRA to Roth IRA conversion may help for some employees.

Those employees who perform Roth IRA conversions during 2019 must report their conversions on IRS Form 8606 (nondeductible IRAs) when they file their 2019 income taxes in spring 2020. Those individuals who perform conversions of traditional IRAs to Roth IRAs during 2019 must pay the full amount of federal and state income taxes due when they file their 2019 income taxes.

Recharacterization - The Undoing of a Roth IRA Conversion

Prior to passage of the Tax Cuts and Jobs Act of 2017 (TCJA), an individual who converted a traditional IRA to a Roth IRA was able to "undo" the conversion, provided this was done before the individual filed his or her current year tax returns. This is called a recharacterization

But as a result of the passage of the Tax Cuts and Jobs Act of 2017 (TCJA)*, effective Jan. 1, 2018 recharacterizations of converted Roth IRA are no longer permitted.* But recharacterization of IRA *contributions* are still permitted under TCJA, as will now will be explained.

Contributions to one type of IRA can be treated as having been to a different type of IRA. For example, contributions to a Roth IRA can be made as treated as contributions to a traditional IRA. This is called *recharacterizing* the contribution.

Why would an individual want to recharacterize an IRA contribution? Once possibility would be the example of an individual who, during calendar year 2019, made a Roth IRA contribution and now in January 2020 has received all of his or her 2019 income information via W-2's and 1099's. The individual has determined that his or her 2019 modified adjusted gross income (MAGI) was over the allowable limit for making a 2019 Roth IRA contribution. A previous FEDZONE column discussed the MAGI limits for making Roth IRA contributions. The individual exceeded the MAGI limit and is eligible to recharacterize the contribution as a *nondeductible traditional IRA contribution*. If the recharacterization is performed in the proper way and before the individual files his or her 2019 federal income tax return, there will be no tax consequences and no penalties.

Here are two examples that illustrates the recharacterization process:

Example 1. (Traditional IRA contribution is recharacterized). Judy is a federal employee covered by FERS, and contributes to the Thrift Savings Plan (TSP). She contributed $5,000 to a new deductible traditional IRA on Sept. 26, 2019. On Jan. 19, 2020, Judy's traditional IRA is worth $5,500. She decides to recharacterize $4,000 of the traditional IRA contribution as a Roth IRA contribution. To accomplish this, Judy has $4,400 ($4,000 contribution plus $400 related earnings) transferred from her traditional IRA to a Roth IRA in a trustee-to-trustee transfer. Judy deducts the $1,000 traditional IRA contribution on her 2019 Form 1040. She is not required to file IRS Form 8606 (Nondeductible IRAs), but she must attach a statement to her 2019 federal tax return that indicates the following:

1. She contributed $5,000 to a traditional IRA on Sept. 26, 2019;
2. She recharacterized $4,000 of that contribution on Jan. 19, 2020 by transferring $4,000 plus $400 of related earnings from her traditional IRA to a Roth IRA in a trustee-to-trustee transfer.
3. The entire $1,000 of the remaining IRA contribution is deducted (as an adjustment to income) on her 2019 Form 1040.

Judy does not report the $4,400 distribution from her traditional IRA on her 2019 Form 1040 because the distribution occurred in 2020. She does not report the distribution on her 2020 Form 1040 because the recharacterization was related to 2019 and was explained in an attachment to her 2019 tax return.

Example 2. (Roth IRA contribution is recharacterized). Kevin is a federal employee. He contributed $4,000 to a new Roth IRA on June 15, 2019. On January 21, 2020, Kevin determined that his 2019 modified adjusted gross income (MAGI) will allow him to fully deduct a traditional IRA contribution. He decides to recharacterize the Roth IRA contribution as a traditional IRA contribution. He has the $4,200 Roth IRA balance ($4,000 contribution plus $200 accrued earnings) transferred from his Roth IRA to a traditional IRA in a trustee-to-trustee transfer on January 21, 2020. Kevin then deducts (as an adjustment to income) the $4,000 traditional IRA contribution on his 2019 federal income tax return. He is not required to file Form 8606 (Nondeductible IRAs), but must attach a statement to his 2019 federal income tax return that indicates that:

1. *He contributed $4,000 to a new Roth IRA on June 15, 2019.*

2. *He recharacterized the contribution on January 21, 2020 by transferring $4,200, the balance in the Roth IRA, to a traditional IRA in a trustee-to-trustee transfer.*
3. *$4,000 of the traditional IRA contribution is deducted (as an adjustment to income) on his 2019 federal income tax return.*

He includes the $4,200 distribution from the Roth IRA on the line for "IRA distributions" on his 2019 federal income tax return.

How to Recharacterize an IRA Contribution

To recharacterize an IRA contribution, the contribution must be transferred from the first IRA (the one to which the contribution was made) to the second IRA *in a direct trustee-to-trustee transfer*. The deadline for the transfer is the due date (including extensions) for the tax return for the year for which the contribution to the first IRA was made. This means that any individual who wants to recharacterize an IRA contribution made for the year 2019 has until October 15, 2020 (the extension deadline for filing 2019 income tax returns).

Individuals who recharacterize their IRA contributions (from a nondeductible traditional IRA contribution to a Roth IRA, or from a Roth IRA to a nondeductible traditional IRA contribution) must do all of the following:

● Instruct the first IRA trustee to *directly transfer* the contribution, as well as any net income net income allocable to it, to the second IRA. If there was a loss, the net income transferred may be a negative amount (in most cases, the net income allocable to the transfer is determined by the IRA trustee or custodian).

● Report the recharacterization on Form 8606 of their federal tax return for the year during which the contribution was made (see below).

● Treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

Reporting a Recharacterization

Individuals who elect to recharacterize a 2019 IRA contribution to one kind of IRA (Roth or non-Roth) as a contribution to another type of IRA must report the recharacterization on their 2019 federal income tax return as directed by IRS Form 8606 and its instructions. To the extent a contribution is recharacterized, it is treated on the tax return as having been made to the second IRA. In addition, a statement that explains the recharacterization must be attached to the 2019 federal income tax return.

When an individual recharacterizes an IRA contribution, the IRA trustee of the first IRA (the IRA to which the contribution originally was made) must report the amount contributed before the recharacterization as *recharacterized contributions* on **Form 5498 Box 4 (IRA Contribution Information) (2020 version**) and the recharacterization as a *distribution* on **2019 Form 1099-R (Distributions from Pensions, Annuities, Insurance Contracts).** A 2019 Form 1099-

R reporting the recharacterized amount as a distribution should show the following codes in Box 7:

- **Code N** if the contribution and recharacterization both occurred in 2019
- **Code R** if the contribution was made for 2018, but recharacterized in 2019

The trustee of the second IRA is required to issue a Form 5498 for 2020 reporting the fair market value of the IRA received on Form 5498 in Box 4.

The following table summarizes the reporting of a recharacterization of an IRA contribution:

Reporting a Recharacterization

Initial Contribution	Recharacterization	Report on IRS Form 8606	Recharacterization and Contribution in the Same Year
Contribution to a nondeductible traditional IRA	Transfer to a Roth IRA	Only the part, if any, of the contribution that is not recharacterized (the amount left in the traditional IRA) to the extent it is nondeductible.	Amount transferred from the traditional IRA to the Roth IRA
Contribution to a Roth IRA	Transfer to a nondeductible traditional IRA	Only the part, if any, of the contribution that is recharacterized to the traditional IRA, to the extent it is nondeductible	Amount transferred from the Roth IRA to the traditional IRA

Finally, under the Tax Cuts and Jobs Act of 2017 (TCJA), effective Jan. 1, 2018, a *conversion* from an existing traditional IRA, a SEP IRA, or a SIMPLE IRA to a Roth IRA cannot be recharacterized**.** TCJA also prohibits recharacterizing amounts rolled over to a Roth IRA from other retirement plans, such as the traditional TSP, 401(k) or 403(b) retirement plans. Therefore, with the passage of TCJA, a recharacterization can only be performed to recharacterize *contributions* made to traditional IRAs and Roth IRA contributions, as discussed and illustrated above.

Chapter 11. Other Uses of IRAs Besides Retirement Savings

Individuals under the age of 59.5 who withdraw funds from a traditional IRA during the year may not be subject to the 10 percent early withdrawal penalty tax if the funds are used to pay for:(1) higher education expenses; and (2) buying, building or rebuilding a first home.

With respect to paying for higher education expenses, qualifying expenses include tuitions, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible educational institution. In addition, if the individual is at least a half-time student, room and board is considered qualifying expenses.

The educational costs must be for the individual IRA owner, for a spouse, or for children or grandchildren. Other relatives (e.g., a nephew or a niece) do not qualify.

Eligible educational institutions include any college, university, vocational school, or other post secondary educational institution eligible to participate in the student aid programs, administered by the Department of Education. Most educational institutions should be able to determine if they are eligible educational institution.

Keep in mind that even though the 10 percent early withdrawal penalty for pre-age 59.5 withdrawals is avoided by using the funds to pay for qualifying expenses, ordinary income taxes (federal and state) are still due. This includes a tax on one's entire deductible IRA (contributions and earnings), while for a non-deductible IRA a tax is due only on the accrued earnings. In the case of Roth IRA's, only accrued earnings (interest, dividends) are subject to a minimum holding period of 5 years; if the earnings are withdrawn for a qualified purpose (e.g., paying for qualified educational expenses or for buying a first home) they are not subject to a 10 percent early withdrawal penalty. Also, with a Roth IRA all contributions may be withdrawn at any time with no penalty.

There will also be no 10 percent additional tax on distributions from IRAs in which funds are used to buy, build, or rebuild a first home. An individual may use in a lifetime no more than $10,000 for this purpose. Therefore, for a married couple, in which both spouses have IRAs, each spouse can receive distributions up to $10,000 in order to buy a first home (a total of $20,000 in a lifetime) without having to pay the 10 percent additional tax.

In order for individuals to qualify for avoiding a penalty on IRA withdrawals as a first-time home buyer, the withdrawal must meet <u>all</u> the following requirements:

· It must be used to pay qualified acquisition costs before the close of the 120th day after the day the distribution is received.

· It must be used to pay qualified acquisition costs for the main home of a first-time homebuyer who is one of the following:

- IRA owner
- IRA owner's spouse
- IRA owner's child/stepchild
- IRA owner's grandchild/step-grandchild
- IRA owner's parents or parents-in-laws

Qualified acquisition costs include:

- Costs of buying, building or rebuilding a home
- Settlement, financing or other closing costs

An obvious question is: Who is a first-time homebuyer? The IRS defines a first-time homebuyer as an individual who has no present interest in a main home during the 2-year period ending on the date of acquisition of the home which the IRA distribution is being used to buy, build or rebuild. For married couples buying a first home, both spouses must meet this no-ownership requirement.

<u>Planning Points for "Early" IRA Withdrawals</u>

1. The $10,000/$20,000 penalty-free IRA withdrawal option is another source of funds for individuals to pay for the increasing costs of higher education as well as for paying for a first-home.

2. In the case of first-home purchasers, many IRA owners live in high cost metropolitan areas in which the cost of housing is prohibitive. Having another source of funds to pay for the cost of buying a first home should help many individuals.

3. Individuals who retire and who also sell their principal residences may want to wait at least two years before purchasing another residence. In so doing, their new home will be considered a "first" home and IRA funds may be tapped to help pay for the purchase of the new home. Coupled with the $250,000/$500,000 capital gain exclusion upon the sale of a principal

residence (Internal Revenue Code Section 121), individuals have an additional incentive and resources in which to pay for the increasing cost of housing.

4. IRA distributions to pay for qualified educational expenses may be used in conjunction with other "tax-favored" programs (such as Coverdell Educational Savings Accounts and 529 plans) to help eligible federal employees pay for the increasing costs of higher education.

Chapter 12. Estate Planning and IRAs

For individuals, estate planning decisions depend primarily on the size of the expected estate. Complexities can be great, however, even when the estate is small. Larger estates (e.g., over $12 million) usually require planning to start much earlier than it would be for a smaller estate. It may be necessary in some cases to call in experts – attorneys, accountants, and life insurance specialists, for additional consultation with regard to estate planning.

With regard to IRAs, the strategy that provides the greatest flexibility after the owner's death is to designate the surviving spouse as the primary beneficiary because he or she can perform a spousal rollover of the decedent's IRA, or alternatively, disclaim in favor of a younger beneficiary. Individuals may also give the IRA directly to children, bypassing the spouse. Trusts may also be appropriate. Therefore, even for smaller estates, the IRA owner may need professional advice as to who is the best individual or entity to name as beneficiary of an IRA.

IRA's are distinguished from other assets in the area of estate planning. This is because of their ability to generate tax deferral (in the case of a traditional IRA) or tax-free income (in the case of a Roth IRA) after the death of the IRA owner. Note that even qualified retirement plan's assets at the time of his or her death may not be rolled over to an IRA if the beneficiary is not the surviving spouse.

Unfortunately, when many IRA owners (particularly traditional IRAs) die, their families sometimes cash in the IRAs and pay the income taxes rather than deal with the complications. That is extremely short-sighted – continuing the IRA and deferring taxes will generally produce significantly greater savings. A well-advised IRA owner will allow his or her family that choice by making the proper choices and provisions.

<u>General Rules on IRA's With Respect to Estate Taxes</u>

IRAs (this includes both traditional IRS and Roth IRAs) are part of an IRA owner's gross estate and is taxed in the same manner as qualified retirement plan benefits (such as the TSP). The IRAs include both the traditional and the Roth IRAs.

IRAs and Federal Employees

For traditional IRAs, any IRA distribution after the IRA owner's death is treated as income in respect of a decedent (IRD) and therefore may be taxed. If an estate tax is also imposed on the distribution, however, the recipient of the distribution is entitled to a deduction against the income tax for the portion of the net federal estate tax that resulted from the same distribution.

One must also keep in mind that while income taxes on a traditional IRA must be paid at the time of distribution, the distribution may be delayed until April 1st following the year in which the traditional IRA owner turns age 70.5 (age 72 if the traditional IRA owner was born after June 30, 1949). In other words, there is a point at which distribution from the traditional (but not the Roth) IRA must begin (as well as income taxes on the IRA).

Income tax planning and estate tax planning are therefore not mutually exclusive activities. Both are important in providing adequately for the needs of the IRA owner's spouse or other individuals chosen by the owner to be heirs. Note that income taxes cannot be eliminated; also, tax-deferred accumulation of an IRA can produce a sizeable increase in the value of the estate. A significant increase in the estate over the applicable estate tax exemption amount may require estate planning for the surviving spouse and other chosen family members.

Beneficiaries

Individuals may name the following as classes of beneficiaries of their IRAs:

- The IRA owner's surviving spouse
- An individual or individuals other than the IRA owner's surviving spouse
- The IRA owner's estate
- A charity
- One or more trusts

If an IRA owner names a spouse as the designated beneficiary, then the spouse need not continue the IRA under the deceased owner's name in order to defer distributions. In fact, the surviving spouse is the only beneficiary who is not required to "cash out" the IRA. In some cases, it may be appropriate to rollover the decedent's IRA into an IRA in the surviving spouse's own name. If the owner's surviving spouse is younger than age 70.5 (72, if born after June 30, 1949), distribution from the decedent's IRA will not begin until the spouse has reached age 70.5 (72). (This applies to a traditional IRA; for a Roth IRA, the surviving spouse may rollover the decedent's Roth IRA to his or her own Roth IRA and is not required to take any distributions).

There are several ways in which a surviving spouse may elect to change the distribution pattern of the decedent's IRA:

- Take a distribution and within 60 days of its receipt, roll it over to a new IRA in his or her own name; or

- Assert ownership of the inherited IRA by notifying the IRA trustee or custodian and discontinuing distribution begun by the decedent or making contributions to the IRA before the year in which the surviving spouse attains age 70.5 (72).

On the other hand, a nonspousal IRA beneficiary has the option of withdrawing the inherited IRA over his or her life expectancy. He or she must take required minimum distribution (RMD) every year and calculate his or her RMD from the IRA using the life expectancy factor based on his or her age in the year following the year of the IRA owner's death. The first distribution must be made by December 31 of the year following the year of the IRA owner's death. In each subsequent year, the IRA beneficiary must subtract one year from the life expectancy factor before dividing it into the IRA year-end balance as of the previous December 31. This is called a "stretch" IRA ("stretching the IRA over the remaining life of the IRA beneficiary).

As a result of the passage of the SECURE Act in December 2019, for all IRA owners who die after Dec. 31, 2019, the "stretch" IRA for nonspousal IRA beneficiaries is no longer available. Under the new rules, a nonspousal beneficiary (with some exceptions) who inherits an IRA (traditional or IRA) will no longer be subject to RMD each year. Instead the inherited IRA will be paid in a lump sum at the end of the 10th year following the death of the IRA owner.

Furthermore, if a non-spouse beneficiary commingled the decedent's IRA with his or her own IRAs, the tax shelter of the decedent's IRA will be destroyed. A nonspousal beneficiary must therefore maintain the inherited IRA in the decedent's name.

A spouse beneficiary also should keep his or her own IRAs separate from the decedent spouse's IRA, although the commingling of IRA's in this case would not disqualify the decedent spouse's IRA from further tax deferral. Commingling the decedent's IRA with the surviving spouse's other IRAs will render the spouse ineligible to claim that age 59.5 distributions from the commingled IRA are exempt from the 10 percent additional penalty tax (Internal Revenue Code Section 72 (t)). This is because the distributions are being made to a beneficiary after the death of the IRA owner.

If a traditional IRA owner dies before his or her required beginning date, an IRA beneficiary must be named no later than December 31 of the year following the year of the IRA owner's death. If an IRA owner dies after his or her required beginning date, then nonspousal beneficiaries will receive their portion of the IRA after 10 years following the death of the IRA owner and pay full income tax in the case of an inherited traditional IRA.

Appendix

Summary Record of Traditional IRA(s) for 2020 (Keep This for Your Records)

Name ________________________________

I was ___ covered __ not covered by my employer's retirement plan during the year.

I became age 59.5 on ____________________________
(month) (day) (year)

I become age 70.5 (72) on ____________________________
(month) (day) (year)

Contributions

Name of traditional IRA	Date	Amount contributed for **2019**	Check, if rollover contribution	Fair Market Value of IRA as of Dec. 31, **2019**, from Form 5498
1.				
2.				
3.				
4.				
5.				
Total				

Total contributions deducted on tax return $____________________

Total contributions treated as nondeductible on Form 8606 $____________________

Distributions

Name of traditional IRA	Date	Amount of distribution	Reason (e.g., for Retirement, rollover, conversion, withdrawal of excess contributions, etc.)	Income earned on IRA	Taxable amount reported on income tax return	Nontaxable amount from Form 8606, line 13
1.						
2.						
3.						
4.						
Total						

Basis of all traditional IRAs for **2019** and earlier years (from Form 8606, line 14) $__________________

Note: *You should keep copies of your income tax return, and Forms W-2, 8606, and 5498.*

WORKSHEET FOR DETERMINING REQUIRED ANNUAL DISTRIBUTIONS

1. Age	70 ½	71 ½	72 ½	73 ½	74 ½	75 ½
2. Year age was reach						
3. Value of IRA at the close of business on December 31 of the year immediately prior to the year on line 2[1]						
4. Distribution period from Table A6 or life expectancy or from IRS joint life expectancy from IRS Publication 590						
5. Required distribution (divide line 3 by line 4)[3]						

[1] If you have more than one IRA, you must figure the required distribution separately for each IRA.
[2] Use the appropriate life expectancy or distribution period for each year and for each IRA.
[3] If you have more than one IRA, you must withdraw an amount equal to the total of the required distributions figured for each IRA. You can, however, withdraw the total from one IRA or from more than one IRA.

Form **8606**

Department of the Treasury
Internal Revenue Service (99)

Nondeductible IRAs

▶ Go to *www.irs.gov/Form8606* for instructions and the latest information.

▶ Attach to 2019 Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074

2019

Attachment Sequence No. **48**

Name. If married, file a separate form for each spouse required to file 2019 Form 8606. See instructions. | **Your social security number**

Fill in Your Address Only if You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street, or P.O. box if mail is not delivered to your home) | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions).

Foreign country name | Foreign province/state/county | Foreign postal code

Part I Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs

Complete this part only if one or more of the following apply.

- You made nondeductible contributions to a traditional IRA for 2019.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2019 **and** you made nondeductible contributions to a traditional IRA in 2019 or an earlier year. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified disaster distribution (see 2019 Forms 8915-C and 8915-D)), qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2019 **and** you made nondeductible contributions to a traditional IRA in 2019 or an earlier year.

Line	Description			
1	Enter your nondeductible contributions to traditional IRAs for 2019, including those made for 2019 from January 1, 2020, through April 15, 2020. See instructions			1
2	Enter your total basis in traditional IRAs. See instructions			2
3	Add lines 1 and 2			3
	In 2019, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion? — **No** ▶ Enter the amount from line 3 on line 14. Do not complete the rest of Part I. — **Yes** ▶ Go to line 4.			
4	Enter those contributions included on line 1 that were made from January 1, 2020, through April 15, 2020			4
5	Subtract line 4 from line 3			5
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2019, plus any outstanding rollovers. Subtract any repayments of qualified disaster distributions (see 2019 Forms 8915-C and 8915-D)	6		
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2019. **Do not** include rollovers (other than repayments of qualified disaster distributions (see 2019 Forms 8915-C and 8915-D)), qualified charitable distributions, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see instructions)	7		
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2019. Also enter this amount on line 16	8		
9	Add lines 6, 7, and 8 — 9			
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	× .	
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11		
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12		
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions			13
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2019 and earlier years**			14
15a	Subtract line 12 from line 7			15a
b	Enter the amount on line 15a attributable to qualified disaster distributions from 2019 Forms 8915-C and 8915-D (see instructions). Also, enter this amount on 2019 Form 8915-C, line 22, **or** 2019 Form 8915-D, line 13, as applicable			15b
c	**Taxable amount.** Subtract line 15b from line 15a. If more than zero, also include this amount on 2019 Form 1040 or 1040-SR, line 4b; or 2019 Form 1040-NR, line 16b			15c

Note: You may be subject to an additional 10% tax on the amount on line 15c if you were under age 59½ at the time of the distribution. See instructions.

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63966F Form **8606** (2019)

Part II 2019 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs

Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2019.

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2019	16	
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see instructions)	17	
18	**Taxable amount.** Subtract line 17 from line 16. If more than zero, also include this amount on 2019 Form 1040 or 1040-SR, line 4b; or 2019 Form 1040-NR, line 16b	18	

Part III Distributions From Roth IRAs

Complete this part only if you took a distribution from a Roth IRA in 2019. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified disaster distribution (see 2019 Forms 8915-C and 8915-D)), qualified charitable distribution, one-time distribution to fund an HSA, recharacterization, or return of certain contributions (see instructions).

19	Enter your total nonqualified distributions from Roth IRAs in 2019, including any qualified first-time homebuyer distributions, and any qualified disaster distributions (see instructions). Also see 2019 Forms 8915-C and 8915-D	19	
20	Qualified first-time homebuyer expenses (see instructions). **Do not** enter more than $10,000 reduced by the total of all your prior qualified first-time homebuyer distributions	20	
21	Subtract line 20 from line 19. If zero or less, enter -0-	21	
22	Enter your basis in Roth IRA contributions (see instructions). If line 21 is zero, **stop here**	22	
23	Subtract line 22 from line 21. If zero or less, enter -0- and skip lines 24 and 25. If more than zero, you may be subject to an additional tax (see instructions)	23	
24	Enter your basis in conversions from traditional, SEP, and SIMPLE IRAs and rollovers from qualified retirement plans to a Roth IRA. See instructions	24	
25a	Subtract line 24 from line 23. If zero or less, enter -0- and skip lines 25b and 25c	25a	
b	Enter the amount on line 25a attributable to qualified disaster distributions from 2019 Forms 8915-C and 8915-D (see instructions). Also, enter this amount on 2019 Form 8915-C, line 23, **or** 2019 Form 8915-D, line 14, as applicable	25b	
c	**Taxable amount.** Subtract line 25b from line 25a. If more than zero, also include this amount on 2019 Form 1040 or 1040-SR, line 4b; or 2019 Form 1040-NR, line 16b	25c	

Sign Here Only if You Are Filing This Form by Itself and Not With Your Tax Return

Under penalties of perjury, I declare that I have examined this form, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature | Date

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

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