Chapter 1: Select Rules for Retirement Plans

There are complex rules associated with traditional individual retirement arrangements (IRAs) that often result in errors or problems. For example, it is essential to understand how basis develops within an IRA, the potential advantages associated with basis in an IRA, and how to track basis. Proper attention to basis issues helps ensure that the taxpayer does not face double taxation on IRA funds and also ensures that any basis in the IRA is properly accounted for when the IRA is inherited by one or more beneficiaries. The basis in an inherited IRA remains with the IRA after the death of the account owner.

Distributions are generally reported on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc. Forms 1099-R are produced by financial institutions that frequently have limited or no tax information about the taxpayer holding the plan. This reporting procedure is also prone to errors and misreporting, especially if the plan had changes, excess contributions, inheritance issues, funding other than cash, or any other complications.

This chapter provides essential details that should prove helpful in understanding common errors associated with IRAs, qualified plans, distributions, and the reporting of distributions.

**BASIS IN A TRADITIONAL IRA**

For 2014, the taxpayer’s general contribution limit is the lesser of:

- $5,500 (plus an additional $1,000 for taxpayers who are age 50 or older before the end of the tax year), or
- The amount of taxable compensation the taxpayer receives in the year.

No further contributions may be made to the taxpayer’s IRA during and after the tax year in which the taxpayer attains age 70½. However, after age 70½, the taxpayer may qualify to make continued contributions to an IRA for a spouse who is under age 70½.

**Note.** For further details on the IRA contribution rules, including use of spousal IRA accounts, see IRS Pub. 590, Individual Retirement Arrangements (IRAs).

Please note. Corrections for all of the chapters are available at www.TaxSchool.illinois.edu. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.
The taxpayer may make an IRA contribution up to the maximum amount allowable, but the actual amount of the contribution that can be deducted may be reduced. Whether there is a reduced deduction for the contribution depends on several factors, such as:

- The taxpayer’s filing status,
- The taxpayer’s modified adjusted gross income (MAGI), and
- Whether the taxpayer (or taxpayer’s spouse, if applicable) is covered by a retirement plan at work at any time during that tax year.4

For 2013 and 2014, the table below shows the phaseout ranges of modified adjusted gross income (MAGI) that apply for traditional IRA contributions when one or more of the taxpayers is covered by another retirement plan.5 These phaseout limits for contributions apply to the following taxpayers.

- Single, married filing separately (MFS), and head of household (HoH) filers participating in an employer retirement plan
- Married filing jointly (MFJ) filers when at least one spouse is covered by an employer retirement plan

For MFJ filers, the phaseout rules apply to both spouses even if only one of the spouses participates in an employer retirement plan. The phaseout ranges vary depending on whose IRA is being funded.

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>2013 MAGI Phaseout Ranges</th>
<th>2014 MAGI Phaseout Ranges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$59,000–69,000</td>
<td>$60,000–70,000</td>
</tr>
<tr>
<td>MFJ (contributing spouse is covered by workplace retirement plan)</td>
<td>95,000–115,000</td>
<td>96,000–116,000</td>
</tr>
<tr>
<td>MFJ (contributing spouse is not covered by workplace retirement plan and other spouse is covered by workplace retirement plan)</td>
<td>178,000–188,000</td>
<td>181,000–191,000</td>
</tr>
<tr>
<td>HoH</td>
<td>59,000–69,000</td>
<td>60,000–70,000</td>
</tr>
<tr>
<td>MFS</td>
<td>0–10,000</td>
<td>0–10,000</td>
</tr>
</tbody>
</table>

The following general rules for these phaseout ranges apply to taxpayers who are covered by a retirement plan at work.

- Taxpayers with MAGI amounts below the ranges shown are entitled to deduct the full amount of their IRA contributions up to the $5,500 per-taxpayer maximum (plus the additional $1,000 that the taxpayer may contribute if age 50 or over).
- Taxpayers with MAGI amounts in the phaseout range are entitled to a reduced IRA deduction.
- Taxpayers with MAGI amounts in excess of the phaseout range cannot deduct any of the contributed amounts.

Taxpayers who do not qualify to make deductible IRA contributions may make nondeductible IRA contributions.6 The amount of nondeductible contributions allowed each year is the general IRA limit for the taxpayer less the amount that the taxpayer deducts for the year.7 The nondeductible contributions provide the taxpayer with basis in their IRA.

**Example 1.** Bruce is a 44-year-old single filer who participates in his employer’s 401(k) plan. His 2014 MAGI is $72,400. He makes the maximum $5,500 IRA contribution. Because Bruce’s MAGI is above the phaseout range for his filing status, he cannot deduct any portion of the $5,500. Bruce’s $5,500 nondeductible contribution provides him with basis of $5,500 in his IRA.

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4. IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*
6. IRC §408(o).
7. IRC §408(o)(2)(B).
PRORATION OF WITHDRAWALS

Nondeductible IRA contributions are not taxable when distributed to the taxpayer or their heirs. If a distribution is made from an IRA that consists of deductible and nondeductible contributions, a formula determines the portion of the distribution that constitutes a nontaxable return of basis.\(^8\) The formula is as follows.

\[
\text{Nontaxable return of basis} = \frac{\text{Total nondeductible contributions} - \text{Amounts previously recovered}}{\text{Total end-of-year IRA balance} + \text{Distribution amount}} \times \text{Distribution amount}
\]

Example 2. Barry has one IRA at Main Street Bank into which the following contributions were made.

<table>
<thead>
<tr>
<th>Taxation Year</th>
<th>Deductible Contributions</th>
<th>Nondeductible Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2007</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>2008</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>1,000</td>
<td>4,000</td>
</tr>
<tr>
<td>2010</td>
<td>1,500</td>
<td>3,500</td>
</tr>
<tr>
<td>2011</td>
<td>4,000</td>
<td>1,000</td>
</tr>
<tr>
<td>2012</td>
<td>4,000</td>
<td>1,000</td>
</tr>
<tr>
<td>2013</td>
<td>3,500</td>
<td>2,000</td>
</tr>
<tr>
<td>Total</td>
<td>$30,000</td>
<td>$15,500</td>
</tr>
</tbody>
</table>

On May 31, 2014, Barry received a $5,000 distribution from his IRA. At the end of 2014, the IRA account balance was $45,000.

The amount of the $5,000 distribution that is considered a nontaxable return of basis is calculated as follows.

\[
\text{Nontaxable return of basis} = \frac{\text{Total nondeductible contributions} - \text{Amounts previously recovered}}{\text{Total end-of-year IRA balance} + \text{Distribution amount}} \times \text{Distribution amount}
\]

\[
= \frac{$15,500 - 0}{\$45,000 + \$5,000} \times \$5,000
\]

\[
= 0.31 \times \$5,000
\]

\[
= \$1,550
\]

When the taxpayer with nondeductible contributions has more than one traditional IRA, the following rules apply when determining how much of a withdrawal is taxable.

- All existing traditional IRAs are treated as one account, including simplified pension (SEP) IRAs and savings incentive match plan for employees (SIMPLE) IRAs.\(^9\)
- All distributions received during the tax year are added together and treated as one distribution.
- The values of all traditional IRAs as of the end of the tax year in which the distributions were made are added together for a total end-of-year IRA value.

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\(^8\) IRS Notice 87-16, 1987-1 CB 446.

\(^9\) Ibid.