

These notes are intended as a study guide. Unfortunately, there are inadvertent errors. These notes do not address everything in the Test Specifications for the 2008 Special Enrollment Examination and are thus unlikely to reflect all of the questions on this examination.

Chapter references are to the Thomas EA Exam Review Course, Part 1

Chapter 25. ALTERNATE MINIMUM TAX (Form 6251)

AMTI = Regular Taxable Income Less Exclusion Items Plus Preference Items

Exclusion items (effect is to increase tax)

Standard deduction (if not itemizing)

NOL

Deductions for state and local taxes net of income from tax refunds

2% of AGI miscellaneous deductions

Home equity interest not used for improvements

Medical expenses between 7.5 and 10% of AGI

Difference in deduction for investment interest paid

interest on private activity bonds

§1202 (partial exclusion of gain on small business stock)

Depletion

Examples of Preference Items and Adjustment (effect is to accelerate tax)

Income on exercise of ISOs

Difference in depreciation

Difference in capital gain (e.g., ISOs)

Differences in loss limitations

Other Adjustments

Personal exemptions

Tentative AMT = 26%/28% of (AMTI – AMT Standard Deduction)

AMT = Tentative AMT less regular tax; Tax is MAX(Regular, Tentative AMT)

AMT CREDIT CARRYOVER (8801)

Tentative AMT is greater than regular tax in current year

AMT Credit Carryover = Prior Carryover

plus AMT on deferral items (= AMT less AMT on exclusion items only)

Tentative AMT is less than regular tax in current year

AMT Credit = MINIMUM(Prior Carryover, Regular Tax – Tentative AMT)

Chapter 26. CHILD AND DEPENDENT CARE CREDIT (2441)

Qualifying person.

- Generally, a dependent child under age 13 when care is rendered.
- A spouse or a dependent (or who would be a dependent save for the AGI or joint return test) who lives with you for more than half the year and who is unable to care for themselves

Must provide provider information, including Tax ID. Cannot pay

- Your dependent
- Your child under 19
- Your spouse or
- The parent of the qualifying child

You (and nondisabled spouse, if married) must have earned income, generally W-2

Expenses must allow you (and spouse if married) to work, to look for work or to attend school full time. Expenses are pro rated between working and not working intervals. Expenses are limited to the earned income of lower earning spouse.

Annual maximum: \$3K for one child, \$6K for more than one child.
Expenses NOT pro rated among children – one sibling can cost \$6K

Reduce by reimbursements and employer dependent care benefits

School fees for pre-kindergarten only

Transportation is generally excluded

Cannot file MFS; married filing as HH is OK.

Credit ranges from 20-35%, based on AGI. (Questions generally assume AGI = earned income.)

Chapter 27. HOUSEHOLD EMPLOYEES

Household: babysitter, nanny, housekeeper, cook, gardener, home health aide who provide services in your home

Big Issue. Employee: you control both the what and the how

Schedule H is required to pay taxes

- Cash wages \geq \$1,500 per year for a specific employee means paying FICA taxes
- Cash wages \geq \$1,000 in a quarter for all employees means FUTA taxes

Also, file W-2

- If wages \geq \$1,500 per year for a specific employee or
- If income tax is withheld

If you pay the tax, gross up wages for income tax but not FICA, FUTA

Do NOT count cash wages paid to

- Your spouse
- Your child < 21 years
- Your parent, unless for “child care.” Note differences from child care credit. For example the age of a qualifying child is <18 rather than <13, and, if you are or were married, that your spouse is physically unable to care for the child full time or you are divorced or widowed.
- An employee <18 for at least some part of the year unless providing household services is the employee’s principal occupation.

Cash wages do not include food, lodging, clothing and bus tokens but do include cash paid in lieu of such items.

Must make advance EIC payments, if requested by employee on W-5.

Must get EIN; do not use SS#

Chapter 28. EARNED INCOME TAX CREDIT

Questionnaire is required.

Taxpayer is barred for two years if reckless disregard for the rules; for ten years if the claim was fraudulent

Earned income:

- Wages
- Net income from self employment
- Gross income of statutory employee
- Nontaxable military benefits which you elect to treat as earned income
- Wages of a minister who is exempt from SE tax.

Not earned income

- Interest and dividends
- Pensions and Social Security benefits
- Alimony
- Unemployment
- Nontaxable military benefits (but can elect).

Disability income reported on a W-2 is earned income; reported on a 1099R is not earned income

Rules for Everyone

1. AGI, including your share of community income, are less than threshold amounts for 0, 1 and >1 qualifying children. Depends on filing status.
2. Valid SS# for you, your spouse (if filing a joint return) and for your qualifying children
3. Cannot file separately; can file as HH if you meet these requirements
4. Must be a US citizen or resident alien for the entire year. (There are special elections that may allow a non resident spouse to be treated as a resident for income tax purposes.)
5. Do not claim the foreign income or foreign housing exclusions
6. Investment income \leq \$2900. Investment income includes net gains, tax-exempt interest, income from rental of personal property, royalties and passive activities income.
7. Earned income. Your share of community earned income and income earned while in prison are not treated as earned income for this purpose

Extra Rules if there is a qualifying child (need not be dependent)

8. Qualifying child must have a SS# and must meet

- Relationship test (child or descendant of your child; sibling or descendant of your sibling);
- Age test (< 19 at the end of the year, < 24 and a student or any age and permanently disabled
- Residency test (lived with you in the US for more than one half of the year.) A homeless shelter counts as a home.

9. Qualifying child cannot be claimed by someone else for EIC purposes.

Qualifying children are allocated for exemption, child tax credit, HH filing status, child care expenses, and EIC purposes on an all or none basis.

10. You cannot be a qualifying child of another person

Extra rules if there is no qualifying child,

11. You (or your spouse if filing a joint return) must be at least age 25 but under age 65 at the end of the year

12. You (or your spouse if filing a joint return) must NOT be the dependant of another, whether or not the dependency is claimed

13. You (or your spouse if filing a joint return) must NOT be the qualifying child of another

14. You (and your spouse if filing a joint return) must have lived in the US for more than one half of the year.

Chapter 29. Other Tax Credits

Nonrefundable (any credit in excess of the tax will not be refunded).

- Adoption Credit
- **Child Tax Credit**

Qualifying Child – child, adopted or foster child or sibling or descendent of either who is a dependent and who also is

- less than age 17 at year's end;
- did not provide half of their own support;
- lived with you for at least half of the year; and
- US citizen or resident (adopted child who lived with you entire year).

The credit could be \$1,000 per qualifying child if modified AGI \leq \$75,000 (S, HH, QW), \$110,000 (MFJ) or \$55,000 (MFS).

Modified AGI is AGI plus any foreign, Puerto Rican or American Samoan income exclusions

If the tax liability limits payment of the full credit, an “additional” tax credit may be available depending on earned income and FICA taxes paid. This credit would be better described as refundable rather than as additional since the \$1,000/child limit remains.

- Credit for Elderly or Disabled
- **Hope and Lifetime Learning Credits**

Only one credit can be claimed for a given student but a family with several students could claim both credits.

Different credits can be claimed for the same student in different years.

Tuition and fees deduction may be better.

Eligible student: yourself, your spouse or your dependent for whom you claim the deduction. (A dependent can claim the credit if the parent forgoes the dependency exemption. Works with high AGI parents.)

Qualified expenses are tuition plus books less reimbursements from scholarships or other tax-free sources. Health expenses, transportation, board and room and the like are NOT qualified expenses.

Hope student: at least half time as a freshman or sophomore at a post secondary institution. No felony drug convictions. Hope credit cannot be claimed for the same student for more than two years.

100% of \$1100 + 50% of remainder; not to exceed \$1650 per student

Lifetime student: one or more postsecondary classes to improve job skills (very generously interpreted); drug convictions OK.

20% of eligible expenses, not to exceed \$2,000 per return.

Not available to MFS filers nor to nonresident and dual status aliens.

- Cloverdell Savings Account – not a credit!
- **Foreign Income and Foreign Housing Exclusions (Form 2555).**

The exclusion is limited to \$87,500 of earned income and claiming this exclusion eliminates eligibility for EIC.

US citizen or US resident alien whose tax home is in the foreign country and who is a bone fide resident in a foreign country for the entire tax year, or physically present in the foreign country for 330 days over any consecutive twelve months.

Foreign SE income is limited to 30% of net profits if capital is an income producing factor; no capital, no limitation. See instructions for Form 2555, line 20. (The text is in error, p. 281).

- **Foreign Tax Credit**

Generally, claimed on Form 1116.

If the foreign tax is on interest and dividends only, is less than \$300 (\$600 MFJ) and is reported on a Form 1099DIV or 1099INT, the credit can be claimed directly on Form 1040, line 51.

Alternately, and less desirably, the tax can be claimed as a deduction rather than as credit on Schedule A.

- Mortgage Interest Credit
- Retirement Savings Contribution Credit
- **AMT Credit** – covered previously
- Alternative Motor Vehicle Credit
- Alternative Fuel Vehicle Fueling Property Credit
- Residential Energy Credit
- Credit for Clean Renewable Energy Bonds

Refundable Credits

- **Excess Social Security or RRA tax withheld**

Credit only applies when the excess tax is withheld because there is more than one employer; otherwise, contact the employer for a refund.

- Credit for tax paid on undistributed capital gains
- Health Coverage Tax Credit

Chapter 30. HOBBY (NOT-FOR-PROFIT) ACTIVITIES

Facts and circumstances test as to whether a business is being operated for profit and as to whether the business is really multiple activities.

The statutory presumption is that a business is being operated for profit if net income is positive in three of the five years (two of seven years for horses) ending with the current year. New businesses can file Form 5213 to claim this presumption on a temporary basis.

The significance of these determinations are that not-for-profit activities report gross income on line 21 rather than Schedule C (or other appropriate business form) and cannot claim deductions in excess of income. Deductions are allowed in the following order to the extent of income and claimed where indicated.

Category 1. Deductions such as real estate taxes, mortgage interest and casualty losses which are deductible whether there is a business purpose or not. These deductions are generally claimed on Schedule A.

Category 2. The ordinary and necessary expenses of the business. These deductions are claimed as miscellaneous itemized deductions subject to 2% of AGI with the usual AMT impact.

Category 3. Depreciation and the like which provide a current deduction in exchange for a reduction in basis. These deductions are claimed as miscellaneous itemized deductions subject to 2% of AGI and they are not allowed as deductions for AMT purposes.

If there are several depreciation items, any limitation is allocated pro rata.

These rules apply to partnerships, S-corporations, trusts, estates and sole proprietorships but not C-corporations.

Not for profit rental income is reported on line 21 and deductions, but not in excess of income, are reported on Schedule A with the ordering as above.

Chapter 31. The Estate Tax Return. Form 706

Who must file. Citizens and residents with a gross estate, plus adjusted taxable gifts, of more than \$2 million. Residency is based on domicile, not green card or other test.

Valuation. Generally, the estate is valued on the date of death based on the facts known at that time. Valuation is messy since there are lots of special situations and lots of litigation.

Alternate Valuation Date. The executor can elect to value the estate on any alternate date within six months of death if the both gross estate and the sum of estate and GST taxes are less on the alternate valuation date. No tax liability means no alternate valuation date. Items disposed of before the alternate valuation date are valued as of the distribution date

Gross estate includes everything owned by the decedent.

“Owned” has a very broad meaning and includes QTIP and revocable trusts and irrevocable trusts with a “retained interest.”

The decedent is presumed to own 100% of joint tenancy property, but this presumption can be overcome with evidence.

The decedent owns one half of community property but whether this is one half of the aggregate value or one half of each item depends on the circumstances.

The gross estate includes gift tax paid within three years of death and life insurance transferred for less than FMV within three years of death.

The gross estate includes the present value of future cash flows that the estate has the right to receive: life insurance payable to the estate; wages earned but not paid, rents, receivables and guaranteed annuity payments; interest accrued to date of death; dividends declared before death; reimbursements and refunds; the excess of estimated tax paid over the decedent’s tax liability for the year of death; judgments assigned to the decedent and potential judgments for pain and suffering.

Due Date. The return and any tax liability are due within nine months of the date of death.

A six month extension for the return is available and strongly advised.

An extension of time to pay is available in very limited circumstances, such as when there is difficulty in gaining control of assets. A closely held business has the option to pay on an extended installment plan.

Taxable estate is the gross estate less allowable deductions

Debts. Nonrecourse mortgages, debts for which the decedent was not liable, are not deducted but instead reduce the FMV of the associated real estate.

Funeral expenses and expenses for last illness, to the extent that the estate is liable for the expenses and the expenses have been paid.

Administrative expenses, including executor, legal and accounting fees (accrued or paid), appraisal and court fees, certain interest and the costs of property maintenance.

Expenses incurred for the benefit of the beneficiaries are not deductible (e.g., selling expenses when property could have been distributed in kind)

Beneficiary's cost of litigation is not deductible.

Interest stemming from an estate tax deficiency is deductible but penalties are not deductible.

Some administrative expenses are deductible on the estate tax return or on the income tax return of the decedent or estate, but not both. Medical expenses paid by the estate are one example.

Credits are allowed for foreign death taxes actually paid and for pre-1971 federal gift taxes paid.

There is also a variable credit, ranging from 20 to 100%, for federal estate tax paid on transfers to the decedent within the prior ten years or within two years after death.

State death taxes are a deduction rather than a credit.

Marital deduction. No deduction is generally allowed for property transferring to a noncitizen spouse.

Charitable deduction is allowed for bequests specified in the will or trust.

BEQUESTS TO NONCITIZEN SPOUSES ARE NOT DEDUCTIONS!

Chapter 32. The Gift Tax Return (709)

When is a gift tax return required?

- Same rules for citizens, residents and nonresident aliens
- Gifts in excess of the \$12K annual exclusion except gifts to spouse
- Gifts to noncitizen spouse in excess of \$125,000 annual exclusion; unlimited exclusion for gifts to citizen spouse.
- Gifts of future interests (remainder interests) require a return, independent of value, because they are not eligible for the exclusion.
- To gift splitting with spouse, donor must be married at the time of gift, cannot remarry later in the year and cannot be a nonresident alien.

All gifts must be split.

Only one return is required if donor makes all gifts and no gift exceeds \$24k.

No gift tax return is required if all gifts are CP and \$24K or less.

- Trusts, estates, partnerships and corporations do NOT file 709s
- To allocate GST tax

Donor is responsible for paying the tax but the IRS will go after the recipient if necessary

Practice note: file returns whenever the valuation is uncertain, so as to start the statute of limitations. E.g., appraised asset as real estate.

Charitable gifts are reported if the 709 is required for other reasons.

Exclusions from gift tax

- Political
- Educational (tuition paid directly to institution)
- Medical (Sch A deductible expenses paid directly to the care provider or insurance company)
- Qualified Disclaimers (written, within 9 months, no benefit, without discretion as to new recipient, irrevocable and unqualified).

Terminable interests, life estates & Qualified Terminable Interest Property.

- In general, the marital deduction does not apply to gifts of a terminable interest.
- Life estates (as opposed to gift for a term of years) qualify for the marital deduction if all four of the following conditions are met.
 1. The spouse is entitled to all income for life

2. The income is paid at least annually
 3. No one has the right to appoint (give) the property to anyone but the spouse.
 4. Spouse has the unlimited right to appoint the property in all circumstances.
- A QTIP is a life estate meeting the first three conditions only. The spouse might be given the right, for example, to choose remainder beneficiaries from among the donor's children but not from among his or her children.

The donor can elect to have QTIP gifts qualify for the marital deduction. The election is made on the gift tax return.

GST

- A "skip" person is donee who is two or more generations below the generation of the donor.
- If the parent is deceased as of the date of the gift, the child of the deceased parent moves up one generation.
- There is a \$12K annual exclusion from GST tax.
 - GST gifts are also subject to the regular tax
 - Practice Note. The annual GST exclusion operates slightly differently from the regular exclusion, especially with respect to gifts in trust.

Qualified Tuition Program (529 plans).

- These gifts are not exempt from gift tax.
- Can elect to treat the gift as being made ratably over five years.
- Report the ratable amount on the Form 709 and the total value of the gift on an attachment to the 709. Trick question!
- Gifts in subsequent years could be taxable if total gifts, including the ratable gift, exceed the annual exclusion.
- Death before the fifth year causes part of the gift to be included in the taxable estate.

Valuation.

FMV

Fully document discounts

Carryover basis

Chapter 33. Final Return for a Decedent (1040)

Report income constructively received before death and deductions paid before death. Income and deductions received or paid after death are reported by the recipient (estate or beneficiary).

Income (deductions) in respect of a decedent. Income (and deductions) earned before death but not received. IRD is included in the gross estate but not reported on the decedent's final return.

IRD is important because it tends to increase estate tax due to the inclusion of the unrecognized tax liability in the taxable estate. (Compare wages received before and after death; the tax on the former is a debt on the 706 but the tax on the latter is not an allowed deduction.)

There is an income tax deduction under 691(c) for estate tax paid on IRD but this deduction only imperfectly corrects for the extra estate tax.

Other IRD: Death between the dividend record date and payment date.

- Installment sales
- Rental income
- Interest income
- Receivables
- Traditional pensions and IRAs
- Annuities payable after death

IRD is generally reported by the estate for income tax purposes. If distributed to or received by a beneficiary, it may reportable to the beneficiary.

Medical Expenses. The decedent's medical expenses paid before death are reported on Schedule A of the final return.

Expenses of the "decedent's last illness" can be treated as an estate tax liability or they can be deducted on the final 1040 so long as the expenses have been paid by the estate within one year of death. This is an election; deducting on the 706 is the default.

YOU can deduct expenses that YOU pay for a deceased spouse or deceased dependent on your tax return in the year paid.

Net Operating Loses and capital loss carryforwards expire at death. Net operating loses can be carried backward from the decedent's final return but not forward to the income tax return of the estate.

Chapter 34

Recordkeeping for Individuals

“Basic records” are those that everyone should keep. These prove income, expenses and the basis in your home and in your investments.

“Specific records” are records that pertain to alimony, business use of the home, charitable contributions, child care expenses, casualty or theft losses et cetera.

I fail to see the distinction. Why are records as to income “basic” whereas alimony income is not? Why is the closing statement on a home purchase “basic” whereas subsequent additions to basis are not? Why are charitable contribution records listed as both “basic” and “specific?” Someone in Washington has too little to do!

Perhaps the distinction is between the records that the IRS has access to (W-2s, 1099s, K-1s) and records to which the IRS does not have ready access.

The IRS says that everyone needs to keep “basic” records” whereas the nature of “specific records” vary from one taxpayer to another.

Statute of Limitations. Begins with the filing of a tax return or SFR

- In general, three years.
- Understatement of gross income by more than 25%: six years. This is gross receipts on a Sch C, for example, rather than net Sch C income.
- Fraud: no limit
- Bad debt/worthless security: seven years
- Collection: ten years?

Consider keeping proof of FICA eligible income indefinitely, or at least until you are comfortable that the SSA’s records are correct.

Chapter 35. Innocent Spouse Relief

Comment: Asterisks mark the sort of topics that the SEE asks about.

*A married couple, filing jointly, are jointly and individually responsible for the accuracy of the return, for the payment of tax and for interest and penalties on any deficiencies, even if they are divorced when the return is examined.

*Each couple is responsible for all of the tax, even the tax on the income earned by the other couple, and the IRS routinely applies refunds from joint returns to liabilities for years before marriage.

If one has any doubt as to the integrity of your spouse, you should not file jointly.

Form 8857, in general

*Requires a joint return with understated tax due to erroneous items traceable to spouse

*File within two years after the IRS first attempts to collect the tax

*NOT eligible after filing an offer in compromise or after entering into a closing statement with respect to the same tax liability or after a court has declined to provide relief from joint liability.

Innocent spouse.

*Innocent spouse did not know and had no reason to know that there was an understatement of tax.

Taking into account all facts and circumstances, it would be unfair to hold the innocent spouse liable for the understated tax, interest and penalties.

Does not affect community property laws. E.g., a California spouse remains liable for community debts – which include tax debts – even if the IRS agrees to hold the spouse innocent.

Separation of Liability

*Must be divorced, widowed or legally separated from the spouse with whom you filed a joint return. Cannot have shared the same household for the twelve months prior to the filing of Form 8857.

Allocates tax, interest and penalties only; does not allocate refunds.

Equitable Relief

Applies to tax liabilities and tax refunds

T/P does not qualify for innocent spouse relief, relief by separation of liability or relief from liability arising from community property law.

No fraudulent asset transfers between spouses; no transfer to avoid tax or the payment of tax; no intent to commit fraud.

You did not pay the tax.

Considering all the facts and circumstances, it would be unfair ...

The income tax liability must be attributable to the other spouse, or to you only by virtue of community property laws.

*Tax Court Review can be requested if

*You disagree with the final IRS determination

*No final determination is received within six months of filing Form 8857

Chapter 36. Individual Retirement Arrangements

IRA contributions cannot exceed “compensation;” when filing jointly, compensation can be earned by either spouse.

Compensation includes wages (Box 1 of Form W-2), net Schedule C and partnership income (provided personal services are a material income producing factor) less the adjustments for FICA tax, pensions and taxable alimony.

Community income is not split for IRA compensation purposes.

IRA contributions cannot exceed \$4,000 in 2007 or \$5,000 if aged fifty or older (“catch-up”). Contributions can be split between traditional and Roth IRAs in any ratio.

No contributions to Roth IRAs if modified AGI exceeds about \$160,000 (MFJ), about \$100,000 (S, HH) or about \$10,000 (MFJ). No contributions to traditional IRAs after age 70.5. (Contributions to Roth IRAs OK after 70.5.)

Contributions to both IRAs can be made as late as April 15 (the filing deadline w/o extensions) for the prior year.

Contributions to Roth IRAs are not deductible.

Contributions to traditional IRAs are deductible if neither the taxpayer nor spouse is covered by a pension plan. (W-2 box is not checked.)

If YOU are covered by an employer pension, you cannot deduct contributions to a traditional IRA if your modified AGI exceeds \$62,000 (single, HH), \$103,000 (MFJ, QW) or \$10,000 (MFS).

If your SPOUSE is covered by an employer pension, you cannot deduct contributions to a traditional IRA if modified AGI exceeds \$166,000 (MFJ) or \$10,000 (MFS).

Nondeductible contributions, Roth contributions and withdrawals from traditional IRAs are reported on Form 8606. \$50 penalty for failure to file.

If you contribute too much, there is a 6% excise tax EACH YEAR unless the contribution and earnings are withdrawn prior to April 15 (October 15 if the return is extended.) The withdrawn earnings are taxable income for the year of the contribution and are subject to the early distribution penalty.

Early distributions from traditional and Roth IRAs are penalized before age 59.5 (or death, disability and a variety of other exceptions). The penalty is 10% (California 2.5%) of the taxable income from the distribution.

Prohibited Investments. Collectibles (art, stamps, coins – not US gold and silver coins). The act of investing is considered a taxable distribution.

Prohibited Transactions.

- Cannot borrow money from and IRA, sell property to an IRA or buy property in an IRA for personal use.

- Cannot use as security for a loan (no margin accounts).
- Cannot own life insurance.
- Penalty is a taxable distribution of the entire IRA as of January 1 of the year in which the prohibited transaction occurs.

An “eligible rollover distribution” is full or partial distribution from an IRA or employer plan (not a tax-exempt 457 plan) in excess of any required minimum distribution. Such distributions can be rolled over free of tax and premature distribution penalties to an IRA or to an employer plan (not a tax-exempt 457 plan).

Hardship distributions, corrective distributions, loans which are treated as distributions and life insurance are not eligible to be rolled over to an IRA.

Rollovers come in two flavors: direct rollovers (“trustee-to-trustee transfers”) and distributions to the participant followed by a contribution within 60-days. Withholding is required on distributions from qualified plans but is generally not required on distributions from IRAs. Trustee-trustee transfers are not distributions; hence no withholding.

A qualified charitable distribution is a direct transfer from an IRA (not pension, SEP-IRA or SIMPLE) to a charity after age 70.5. It is not reported on the tax return: no income and no charitable deductions. Qualified charitable distributions count for RMD purposes.

Distributions from traditional IRAs are taxed as ordinary income. Basis is recovered *pro rata* (see Form 8606 for methodology.)

“Qualified distributions” from Roth IRAs (after five years and age 59.5 or death, disability new home purchase) are not taxed or penalized. Non qualified distributions are taxed, but basis is recovered first, and may be penalized, but the penalty is assessed on taxable income only.

Roth IRAs do not require distributions before death. The first required minimum distribution from traditional IRAs and from most traditional-type pensions must be taken no later than April 1 of the year following age 70.5. the first required distribution from an inherited traditional or Roth IRA must be taken by the end of the year after death. Failure to take a required distribution results in a 50% penalty, although abatement can be requested on Form 5329. California has no such penalty.

Conversion is the process of distributing some or all of a traditional IRA, which creates an income tax liability, and contributing the distribution to a Roth IRA. There is no premature distribution penalty on a conversion. Conversions are prohibited if modified AGI exceeds \$100,000 or if MFS.

A conversion can be recharacterized, generally by October 15 of the following year, for any reason. The recharacterization must be a trustee-to-trustee transfer and must include earnings since the conversion date.

A failed conversion which is not recharacterized in a timely manner is expensive: tax, possibly a premature distribution penalty and a 6% excise tax on the excess contribution to the Roth IRA.

Transfers incident to a divorce (QDRO). Tax and penalty-free by trustee-to-trustee transfer, by retitling or by a distribution to the ex-spouse followed by contribution to IRA or pension FBO the ex-spouse within 60 days.

Chapter 37. (Employer-sponsored) Retirement Plans

The IRS publications group tax-advantaged savings plans into four categories. Small Business (Pub 560), Tax Sheltered Annuities (Pub 571), IRAs (Publication 590) and 457 plans (Pub 4406).

While there are similarities among these plans and significant differences. Fortunately, the SEE example focuses on the similarities! Questions on TSAs and 457 plans are unlikely.

A “Keogh” plan is simply a qualified plan established by a self-employed person. There were historical reasons for this distinction but the only current difference is the definition of compensation.

Compensation for a self-employed individual is net earnings from self employment less the pension contribution less one half of the SE tax. This is equivalent to limiting the pension deduction for a self-employed individual (and hence the contribution) to the lesser of \$45,000 or the sum of any elective deferral plus 20%¹ of (net earnings from self employment less one half of the SE tax.)

Self-employed pensions are deducted on line 28 of Form 1040.

Qualified Plans (401a plans)

Defined benefit

Defined contribution – e.g., 401k, MPP

- 403b (Publication 571)
- 457 (governmental plan is treated differently from tax exempt plan)
- IRA plans – described in Pub 590 rather than Pub 560 or 571

SEP and SARSEP

SIMPLE (legally, a form of IRA)

NOT traditional and Roth IRAs

Salary Reduction Arrangements (Deferred Compensation)

¹ If Pension = 0.25 * (Compensation – 0.5 SE – Pension), then

Pension = (0.25 / 1.25) * (Compensation – 0.5 SE) = 0.20 * (Compensation – 0.5 SE).

- 401k, 403, 457 and SARSEP (older SEP) plans are limited to the lesser of 100% of compensation or \$15,500 (\$20,500 aged fifty and older). \$15,500 is the “402(g) limit;” it applies per taxpayer.

SIMPLE plans are limited to \$10,500 (13,000 aged 50 or older)

Deduction Limits

- Defined contribution plans cannot deduct more than the lesser of 25% of total eligible payroll, 100% of the compensation for a given employee or \$45,000 (\$50,000 if “catch-up”) for a given employee.
- SEP plans cannot deduct more than 25% of each employee’s compensation or \$45,000 (\$50,000 if “catch-up”) for a given employee.
- The maximum deduction for defined contribution and SEP plans is the “415(c) limit” and the limit applies on a per employer basis.
- SIMPLE plans can deduct the maximum elective deferral by their employees plus up to 3% of compensation of the employees who make elective deferrals or 2% of compensation of all employees if the employer does not match elective deferrals.
- Eligible compensation for any of the plans is limited to \$225,000.

Distributions of noncash property from a qualified plan. Noncash property can be rolled over or it can be sold and the sale proceeds rolled over. A participant cannot retain the property and rollover cash equal to value of the property. Life insurance cannot be rolled over to an IRA.

Set-up and contribution dates

- 401(k). December 31 or prior to the first elective deferrals. Elective deferrals must be paid on a schedule set by DOL and employer contributions must be paid by the due date (including extensions) of employer’s tax return.
- SEP. The due date of employer’s tax return, including extensions. Can contribute as late as the due date of employer’s tax return.
- SIMPLE plan. Generally, by October 1 of the effective year. Elective contributions must be paid within 30 days of the end of the month and employer contributions must be paid by the due date (including extensions) of the employer’s tax return.
- Elective contributions for sole proprietors are due with the tax return. Contributions can be moved from one year to the following year before the filing of the tax return.

Employment taxes. Elective deferrals to IRAs and to retirement plans are subject to FICA/FUTA taxes. Employer contributions, including employer matching of elective deferrals, are exempt from FICA/FUTA tax.

32 hours preparation time