

Announcement 86-121

Deductibility of Traditional IRA contributions

This announcement highlights some of the changes made by the Tax Reform Act of 1986 (the Act) with respect to Individual Retirement Arrangements (IRAs). The announcement is intended to be a non-technical explanation, rather than a comprehensive statement of the new rules concerning IRAs.

For a non-technical explanation of the rules in effect before the new Act, as well as an explanation of the new law, see Internal Revenue Service Publication 590, which will be available at any IRS District office beginning early in January 1987.

This announcement may be used by a master or prototype IRA sponsor to update its disclosure statement, required by Treasury Regulations at section 1.408-6.

The Service expects to publish technical guidance concerning the Act changes to IRAs in the near future.

The non-technical explanation follows:

The Tax Reform Act of 1986 (which we will call the Act) makes a number of major changes to the law governing the deductibility of contributions to Individual Retirement Arrangements (IRAs).

The changes made by the Act are generally not effective until January 1, 1987. This means that contributions made for 1987 are subject to the Act's new rules; however, you can still make a contribution for 1986 as late as April 15, 1987 under old rules.

Eligibility

Under the new law, if neither you, nor your spouse, is an active participant (see A. below) you may make a contribution of up to the lesser of \$2,000 (or \$2,250 in the case of a spousal IRA) or 100% of compensation and take a deduction for the entire amount contributed. If you are an active participant but have an adjusted gross income (AGI) below a certain level (see B. below), you may make a deductible contribution as under current law. If, however, you or your spouse is

an active participant and your combined AGI is above the specified level, the amount of the deductible contribution you may make to an IRA is phased down and eventually eliminated.

A. Active Participant

You are an “active participant” for a year if you are covered by a retirement plan. You are covered by a “retirement plan” for a year if your employer or union has a retirement plan under which money is added to your account or you are eligible to earn retirement credits. For example, if you are covered under a profit-sharing plan, certain government plans, a salary reduction arrangement (such as a tax sheltered annuity arrangement or a 401(k) plan), a simplified employee pension plan (SEP) or a plan which promises you a retirement benefit which is based upon the number of years of service you have with the employer, you are likely to be an active participant. Your Form W-2 for the year, starting with the 1987 tax year, should indicate your participation status.

You are an active participant for a year even if you are not yet vested in your retirement benefit. Also, if you make required contributions or voluntary employee contributions to a retirement plan, you are an active participant. In certain plans you may be an active participant even if you were only with the employer for part of the year.

You are not considered an active participant if you are covered in a plan only because of your service as (1) an Armed Forces Reservist, for less than 90 days of active service, or (2) a volunteer firefighter covered for firefighting service by a government plan. Of course, if you are covered in any other plan, these exceptions do not apply.

If you are married but file a separate tax return, your spouse’s active participation does not affect your ability to make deductible contributions.

B. Adjusted Gross Income (AGI)

If you are an active participant, you must look at your Adjusted Gross Income for the year (if you and your spouse file a joint tax return and you use your combined AGI) to determine whether you can make a deductible IRA contribution. Your tax return will show you how to calculate your AGI for this purpose. If you are at or below a certain AGI level, called the Threshold Level, you

are treated as if you were not an active participant and can make a deductible contribution under the same rules as a person who is not an active participant.

If you are single, your threshold AGI level is \$25,000. The threshold level if you are married and file a joint tax return is \$40,000, and if you are married but file a separate tax return, the threshold level is \$0.

If your AGI is less than \$10,000 above your threshold level, you will still be able to make a deductible contribution but it will be limited in amount. The amount by which your AGI exceeds your Threshold Level (AGI - Threshold Level) is called your Excess AGI. The Maximum Allowable Deduction is \$2,000 (or \$2,250 for a Spousal IRA). You can estimate your Deduction Limit using Table I on Page 8, or calculate it as follows:

(Your Deduction Limit may be slightly higher if you use this formula rather than the Table).

$$\frac{\$10,000 - \text{Excess AGI}}{\$10,000} \times \text{Maximum Allowable Deduction Limit}$$

You must round up the result to the next highest \$10 level (the next highest number which ends in zero). For example, if the result is \$1,525, you must round it up to \$1,530. If the final result is below \$200 but above zero, your Deduction Limit is \$200. Your Deduction Limit cannot, in any event, exceed 100% of your compensation.

Example 1: Ms Smith, a single person, is an active participant and has an AGI of \$31,619. She calculates her deductible IRA contribution as follows:

Her AGI is \$31,619

Her Threshold Level is \$25,000

Her Excess AGI is (AGI - Threshold Level) or (\$31,619 - \$25,000) = \$6,619

Her Maximum Allowable Deduction is \$2,000

So, her IRA deduction limit is:

$$\frac{\$10,000 - \$6,619}{\$10,000} \times \$2,000 = \$676 \text{ (rounded to \$680)}$$

Example 2: Mr. and Mrs. Young file a joint tax return. Each spouse earns more than \$2,000 and one is an active participant. They have a combined AGI of \$44,255. They may each contribute to an IRA and calculate their deductible contributions to each IRA as follows:

Their AGI is \$44,255

Their Threshold Level is \$40,000

Their Excess AGI is (AGI - Threshold Level) or (\$44,255 - \$40,000) = \$4,255

The Maximum Allowable Deduction for each spouse is \$2,000

So, each spouse may compute his or her IRA deduction limit as follows:

$$\frac{\$10,000 - \$4,255}{\$10,000} \times \$2,000 = \$1,149 \text{ (rounded to \$1,150).}$$

Example 3: If, in example 2, Mr. Young did not earn any compensation, or elected to be treated as earning no compensation, Mrs. Young could establish a Spousal IRA (consisting of an account for herself and one for her husband). The amount of deductible contributions which could be made to the two IRAs is calculated using a Maximum Allowable Deduction of \$2,250 rather than \$2,000.

$$\frac{\$10,000 - \$4,255}{\$10,000} \times \$2,250 = \$1,293 \text{ (rounded to \$1,300).}$$

The \$1,300 can be divided between the two accounts, but neither IRA may receive a deductible contribution of more than \$1,150.

Example 4: Mr. Jones, a married person, files a separate tax return and is an active -- participant. He has \$1,500 of compensation and wishes to make a deductible contribution to an IRA.

His AGI is \$1,500

His Threshold Level is \$0

His Excess AGI is (AGI - Threshold Level) or $(\$1,500 - \$0) = \$1,500$

His Maximum Allowable Deduction is \$2,000

So, his IRA deduction limit is:

$$\frac{\$10,000 - \$1,500}{\$10,000} \times \$2,000 = \$1,700$$

Even though his IRA deduction limit under the formula is \$1,700, Mr. Jones may not deduct an amount in excess of his compensation, so, his actual deduction is limited to \$1,500.

Spousal IRAs

As noted in Example 3 above, under the Act you may contribute to a Spousal IRA even if your spouse has earned some compensation during the year. Provided your spouse does not make a contribution to an IRA, you may set up a Spousal IRA consisting of an account for your spouse as well as an account for yourself. The maximum deductible amount for the spousal IRA is the lesser of \$2,250 or 100% of compensation. This rule applies for 1986 spousal IRAs as well as 1987 spousal IRAs.

Nondeductible Contributions to IRAs

Even if you are above the threshold level and thus may not make a deductible contribution of \$2,000 (\$2,250 for a spousal IRA), you may still contribute up to the lesser of 100% of compensation or \$2,000 to an IRA (\$2,250 for a Spousal IRA). The amount of your contribution which is not deductible will be a nondeductible contribution to the IRA. You may also choose to make a contribution nondeductible even if you could have deducted part or all of the contribution. Interest or other earnings on your IRA contribution, whether from deductible or nondeductible contributions, will not be taxed until taken out of your IRA and distributed to you.

If you make a nondeductible contribution to an IRA you must report the amount of the nondeductible contribution to the IRS as a part of your tax return for the year.

You may make a \$2,000 contribution at any time during the year, if your compensation for the year will be at least \$2,000, without having to know how much will be deductible. When you fill out your tax return you may then figure out how much is deductible.

You may withdraw an IRA contribution made for a year any time before April 15 of the following year. If you do so, you must also withdraw the earnings attributable to that portion and report the earnings as income for the year for which the contribution was made. If some portion of your contribution is not deductible, you may decide either to withdraw the nondeductible amount, or to leave it in the IRA and designate that portion as a nondeductible contribution on your tax return.

IRA Distributions

Because nondeductible IRA contributions are made using income which has already been taxed (that is, they are not deductible contributions), the portion of the IRA distributions consisting of nondeductible contributions will not be taxed again when received by you. If you make any nondeductible IRA contributions, each distribution from your IRAs will consist of a nontaxable portion (return of nondeductible contributions) and a taxable portion (return of deductible contributions, if any, and account earnings).

Thus, you may not take a distribution which is entirely tax-free. The following formula is used to determine the nontaxable portion of your distributions for a taxable year:

$$\frac{\text{Remaining nondeductible contributions}}{\text{Year-end total IRA account balances}} \times \text{Total Distributions (for the year)} = \text{Nontaxable Distributions (for the year)}$$

To figure the year-end total IRA account balance you treat all of your IRAs as a single IRA. This includes all regular IRAs, as well as Simplified Employer Pension (SEP) IRAs, and Rollover IRAs. You also add back the distributions taken during the year.

Example: An individual makes the following contributions to his or her IRAs:

Year	Deductible	Nondeductible
1983	\$2,000	
1984	1,800	
1987	1,000	\$1,000
1989	<u>600</u>	<u>1,400</u>
	\$5,400	\$2,400

Deductible Contributions:	\$5,400
Nondeductible Contributions:	2,400
Earnings on IRAs:	<u>1,200</u>

Total Account Balance of
IRAs as of 12/31/91 \$9,000
(including distributions in 1991)

In 1991 the individual takes a distribution of \$3,000. The total account balance in the IRAs on 12/31/91 plus 1991 distributions is \$9,000. The nontaxable portion of the distributions for 1991 is figured as follows:

Total nondeductible contributions	$\$2,400 \times \$3,000 = \$800$
Total account balance in the IRAs plus distributions	\$9,000

Thus, \$800 of the \$3,000 distribution in 1991 will not be included in the individual's taxable income. The remaining \$2,200 will be taxable for 1991.

Rollover IRA Rules

The Act made some changes in the rules for rollovers of partial distributions from retirement

plans into IRAs. (A partial distribution is one which represents at least 50 percent of the amount owed to you from a retirement plan.)

After December 31, 1986, if you receive a partial distribution from an employer's pension plan after December 31, 1986, and the distribution is paid to you

(1) because you separated from service with the employer,

(2) because you became disabled while working for the employer, or

(3) because of the death of your spouse while he or she was covered under the employer's plan, if you are named as a beneficiary, then you may deposit that amount into a Rollover IRA.

IRA Arrangements

In general, the above changes affect individual deduction provisions, rather than provisions required in IRA documents. Therefore, until further notice, trustees using Model IRAs and IRAs which have been approved under the IRA National Office Master and Prototype program need not amend their IRA documents to reflect the changes in the laws concerning IRAs.

ESTIMATED DEDUCTION TABLE

If your Maximum Allowable Deduction is \$2,000, use this table to estimate the amount of your contribution which will be deductible.

Excess		Excess		Excess		Excess		Excess	
<u>AGI</u>	<u>Deduction</u>	<u>AGI</u>	<u>Deduction</u>	<u>AGI</u>	<u>Deduction</u>	<u>AGI</u>	<u>Deduction</u>	<u>AGI</u>	<u>Deduction</u>
\$ 0.00	\$2,000.00	\$2,000.00	\$1,600.00	\$4,000.00	\$1,200.00	\$6,000.00	\$800.00	\$ 8,000.00	\$400.00
50.00	1,990.00	2,050.00	1,590.00	4,050.00	1,190.00	6,050.00	790.00	8,050.00	390.00
100.00	1,980.00	2,100.00	1,580.00	4,100.00	1,180.00	6,100.00	780.00	8,100.00	380.00
150.00	1,970.00	2,150.00	1,570.00	4,150.00	1,170.00	6,150.00	770.00	8,150.00	370.00
200.00	1,960.00	2,200.00	1,560.00	4,200.00	1,160.00	6,200.00	760.00	8,200.00	360.00
250.00	1,950.00	2,250.00	1,550.00	4,250.00	1,150.00	6,250.00	750.00	8,250.00	350.00
300.00	1,940.00	2,300.00	1,540.00	4,300.00	1,140.00	6,300.00	740.00	8,300.00	340.00

350.00	1,930.00	2,350.00	1,530.00	4,350.00	1,130.00	6,350.00	730.00	8,350.00	330.00
400.00	1,920.00	2,400.00	1,520.00	4,400.00	1,120.00	6,400.00	720.00	8,400.00	320.00
450.00	1,910.00	2,450.00	1,510.00	4,450.00	1,110.00	6,450.00	710.00	8,450.00	310.00
500.00	1,900.00	2,500.00	1,500.00	4,500.00	1,100.00	6,500.00	700.00	8,500.00	300.00
550.00	1,890.00	2,550.00	1,490.00	4,550.00	1,090.00	6,550.00	690.00	8,550.00	290.00
600.00	1,880.00	2,600.00	1,480.00	4,600.00	1,080.00	6,600.00	680.00	8,600.00	280.00
650.00	1,870.00	2,650.00	1,470.00	4,650.00	1,070.00	6,650.00	670.00	8,650.00	270.00
700.00	1,860.00	2,700.00	1,460.00	4,700.00	1,060.00	6,700.00	660.00	8,700.00	260.00
750.00	1,850.00	2,750.00	1,450.00	4,750.00	1,050.00	6,750.00	650.00	8,750.00	250.00
800.00	1,840.00	2,800.00	1,440.00	4,800.00	1,040.00	6,800.00	640.00	8,800.00	240.00
850.00	1,830.00	2,850.00	1,430.00	4,850.00	1,030.00	6,850.00	630.00	8,850.00	230.00
900.00	1,820.00	2,900.00	1,420.00	4,900.00	1,020.00	6,900.00	620.00	8,900.00	220.00
950.00	1,810.00	2,950.00	1,410.00	4,950.00	1,010.00	6,950.00	610.00	8,950.00	210.00
1,000.00	1,800.00	3,000.00	1,400.00	5,000.00	1,000.00	7,000.00	600.00	9,000.00	200.00
1,050.00	1,790.00	3,050.00	1,390.00	5,050.00	990.00	7,050.00	590.00	9,050.00	200.00
1,100.00	1,780.00	3,100.00	1,380.00	5,100.00	980.00	7,100.00	580.00	9,100.00	200.00
1,150.00	1,770.00	3,150.00	1,370.00	5,150.00	970.00	7,150.00	570.00	9,150.00	200.00
1,200.00	1,760.00	3,200.00	1,360.00	5,200.00	960.00	7,200.00	560.00	9,200.00	200.00
1,250.00	1,750.00	3,250.00	1,350.00	5,250.00	950.00	7,250.00	550.00	9,250.00	200.00
1,300.00	1,740.00	3,300.00	1,340.00	5,300.00	940.00	7,300.00	540.00	9,300.00	200.00
1,350.00	1,730.00	3,350.00	1,330.00	5,350.00	930.00	7,350.00	530.00	9,350.00	200.00
1,400.00	1,720.00	3,400.00	1,320.00	5,400.00	920.00	7,400.00	520.00	9,400.00	200.00
1,450.00	1,710.00	3,450.00	1,310.00	5,450.00	910.00	7,450.00	510.00	9,450.00	200.00
1,500.00	1,700.00	3,500.00	1,300.00	5,500.00	900.00	7,500.00	500.00	9,500.00	200.00
1,550.00	1,690.00	3,550.00	1,290.00	5,550.00	890.00	7,550.00	490.00	9,550.00	200.00
1,600.00	1,680.00	3,600.00	1,280.00	5,600.00	880.00	7,600.00	480.00	9,600.00	200.00
1,650.00	1,670.00	3,650.00	1,270.00	5,650.00	870.00	7,650.00	470.00	9,650.00	200.00
1,700.00	1,660.00	3,700.00	1,260.00	5,700.00	860.00	7,700.00	460.00	9,700.00	200.00
1,750.00	1,650.00	3,750.00	1,250.00	5,750.00	850.00	7,750.00	450.00	9,750.00	200.00
1,800.00	1,640.00	3,800.00	1,240.00	5,800.00	840.00	7,800.00	440.00	9,800.00	200.00
1,850.00	1,630.00	3,850.00	1,230.00	5,850.00	830.00	7,850.00	430.00	9,850.00	200.00

1,900.00	1,620.00	3,900.00	1,220.00	5,900.00	820.00	7,900.00	420.00	9,900.00	200.00
1,950.00	1,610.00	3,950.00	1,210.00	5,950.00	810.00	7,950.00	410.00	9,950.00	200.00
								10,000.00	0.00

Excess AGI = Your AGI minus your Threshold Level:

If you are single, your Threshold Level is \$25,000.

If you are married, your Threshold Level is \$40,000.

If you are married and file a separate tax form, your Excess AGI = your AGI.