

RETIREMENT ISSUES

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Learning Objectives

After completing this session, participants will be able to perform the following job-related actions:

- ✓ Conduct a regular review of retirement plan operations
- ✓ Understand the information reported on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- ✓ Explain the tax treatment of nonqualified annuities
- ✓ Explain who qualifies for reverse mortgages, how they work, and when to use them
- ✓ Understand the tax treatment of net unrealized appreciation in employer securities
- ✓ Advise clients on the tax consequences of selling a business when the client retires

ISSUE 1: CHECKLISTS FOR RETIREMENT PLANNING Retirement planning checklists help practitioners conduct a regular review of plan operations.

This issue details steps to be taken on an annual basis to keep retirement plans up to date and in compliance with IRS regulations. It provides annual checklists for SEPs, SIMPLEs, 401(k)s, and traditional and Roth IRAs.

SEP

A Simplified Employee Pension plan (SEP) allows an employer to fund a retirement plan for itself and its employees. Only the employer can make

contributions to the plan, and the employees are fully vested at the time of the initial contribution.

Check for Changes in the Law

Many small business owners choose a model SEP, such as Form 5305-SEP, Simplified Employee Pension–Individual Retirement Accounts Contribution Agreement, which ensures that the plan complies with the law. The most recent version of Form 5305-SEP is from December 2004. However, the law can change, and business owners should visit the IRS website before the end of each year to check for any changes to the model form. Not every change requires adoption of a new plan; and the instructions for Form 5305-SEP specify whether it is necessary to adopt the new version.



Observation SEP Plan Updates

Business owners should maintain regular contact with the company that sold them the plan, because the company typically sends required updates. This applies to plans that do not use the model Form 5305-SEP as well as to plans that use the model form.

Identify Any Related Employers

If taxpayers or their family members own another business, the employees of the other businesses may have to be treated as employees under the SEP. Business owners should identify all other trades and businesses that are controlled, under common control, or affiliated service groups, and determine whether employees of the related trades or businesses have to be included in the plan pursuant to I.R.C. § 414(b), (c), and (m). If employees of a related employer were improperly excluded from participating in the plan, the employer must make a corrective contribution for all excluded employees. This does not affect the amount that was paid to the employees who were originally covered under the plan. The employer must also make a reasonable effort to determine what the investment results would have been if the excluded employees had been timely included in the plan. Rev. Proc. 2013-12, 2013-4 I.R.B. 313, provides safe harbor methods for making the corrections. Rev. Proc. 2015-27, 2015-16 I.R.B. 914,

clarifies available correction methods for certain overpayments, and Rev. Proc. 2015-28, 2015-16 I.R.B. 920, provides additional safe harbor correction methods.

Review Employee Eligibility for Participation in the SEP

To participate in a SEP, an employee must be at least 21 years of age, must have been employed by the business for 3 of the past 5 years, and must have received compensation of at least \$600 during the current year. Business owners can make the rules less restrictive, but not more restrictive. Part-time and seasonal employees, and employees who die or terminate employment during the year, may be eligible to participate in the plan.



Observation Keeping Track of Employees

It is easy to lose track of eligible employees who were previously ineligible because of age, length of employment, or wages paid. Keeping track of the hire dates and anticipated date of eligibility makes it easier for the business owner to ensure that all eligible employees participate in the plan. If an employee was improperly excluded, Rev. Proc. 2013-12, *supra*, details the available correction methods.

Determine If Employee Compensation Was Calculated Correctly

For 2015 the amount of compensation taken into account under the plan is limited to \$265,000 for each employee. Compensation is defined by the plan documents. Under Form 5305-SEP compensation includes bonuses, commissions, and salary. Some plans have a more complex definition of compensation, which may also include expense reimbursements, car allowances, and overtime pay. The calculation of compensation must be based on the definition in the plan.

Verify That Contributions Are Based on a Uniform Percentage

Employer contributions to all SEPs during the year must be a uniform percentage of each

participant's compensation, but they will not all receive the same dollar amount. If the contribution for the year is a lump sum, which is then allocated to the participants, it is easy to make a mistake. If an employee's percentage is less than the percentage of compensation the other employees received, the employer must make a corrective contribution.

Review SEP Contribution Limits

Contributions can be made only to traditional IRAs set up for each eligible employee, and they are limited to the lesser of 25% of compensation or \$53,000 for 2015. Individual SEP plans may have lower contributions limits, which take precedence over the Internal Revenue Code limits. An employee whose compensation is the maximum allowable amount of \$265,000, and whose company pays 25% of compensation, is limited to a \$53,000 contribution for 2015.

In the case of a self-employed owner or partner, the percentage limitation is 20% (0.25 divided by 1.25) after the deduction for the retirement contribution on page 1 of Form 1040.

SIMPLE IRA

SIMPLEs allow employer and employee contributions to a traditional IRA for the employee. SIMPLEs can be used by businesses with 100 or fewer employees who received \$5,000 or more in compensation during the preceding calendar year. Employees are always fully vested in a SIMPLE.

Check for Changes in the Law

The IRS model plan for the SIMPLE is either Form 5304-SIMPLE, Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—Not for Use With a Designated Financial Institution, or Form 5305-SIMPLE, Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—for Use With a Designated Financial Institution. The revision date is located in the top left-hand corner of the form. The current revision date is March 2012, but no changes are required if the plan was established under the March 2002, August 2005, or September 2008 versions. Business owners should check the IRS website annually to be sure their version

is up to date, and they should read the form instructions to determine if they are required to adopt a newer version.

Confirm That the Business Had 100 or Fewer Employees

A business cannot offer a SIMPLE if more than 100 employees earned at least \$5,000 during the prior year. Full-time, part-time, and seasonal employees are included. Leased employees must be included if they are substantially full-time and under the control and direction of the employer. Employees of a business under common control, a controlled group, and an affiliated service group are included in the 100-employee limit. There is a grace period that is available if the SIMPLE was in existence for at least 1 year before the business exceeded the 100-employee limit.



Cross-Reference

Controlled Groups

See the "Business Issues" chapter in this book for a discussion of controlled groups.



Practitioner Note

Contributions Made to Plan with More Than 100 Employees

If the employer made contributions to a plan that did not qualify as a SIMPLE because there were more than 100 employees, the contributions must cease. The employer can file an application to request that amounts contributed in previous years remain in the employees' accounts.

Determine If There Were Other Plans Sponsored by the Business

Contributions to a SIMPLE are not allowed if an employee receives an allocation of contributions to a defined contribution plan [a 401(k), profit-sharing plan, money purchase plan, 403(b), or SARSEP] sponsored by the same employer, or accrues a benefit in a defined benefit plan sponsored by the same employer. The company can maintain a SIMPLE and another type of retirement plan only if there are employees covered under collective bargaining agreements, and

those employees are excluded from the SIMPLE; or if there are separate employees of a business that was part of an acquisition or disposition during the current year or the 2 prior years.

Verify That All Eligible Employees Are Allowed to Participate in the Plan

Salary is the only restriction on employee participation in the plan. If the employer expects that the employee will receive at least \$5,000 in compensation in the current year, and the employee received at least \$5,000 in any prior 2 years, the employee is eligible to participate in the plan. The employer can choose to increase the number of eligible employees by decreasing the \$5,000 minimum amount or by eliminating it altogether.

If an eligible employee was excluded, the employer must take action to correct the missed deferral opportunity. The safe harbor correction methods assume that the employee would have contributed 3% of compensation, so the employer must contribute a makeup amount of 1.5% (one-half of the missed contribution) plus earnings from the date the contribution should have been made until the date of correction. *Earnings* is the adjustment of the principal amount to reflect subsequent investment gains and losses [Rev. Proc. 2013-12, 2013-4, I.R.B. 313].

The employer must also make corrective contributions for missed employer contributions.

- **Three-percent match:** If the plan requires a 3% match, the employer must make a corrective contribution of 3% of the employee's compensation plus earnings.
- **Two-percent nonelective contribution:** If the plan calls for a 2% nonelective contribution, it does not matter if the employee made an elective deferral. The employer has to make a corrective contribution of 2% of the employee's compensation plus earnings.

Review the Calculation of Employee Compensation

The SIMPLE plan document defines compensation. In general, compensation includes wages, tips, bonuses, overtime, commissions, and all other compensation subject to federal income tax withholding. It also includes elective deferral contributions made to the plan by the employee.

If the employer did not use the correct compensation amount to determine deferrals and contributions, the employer must make corrective contributions. The employer has to contribute 50% of what the employee would have contributed, which is the employee's actual deferral percentage multiplied by the excluded compensation. The employer must also contribute the employer contribution under the plan, which is the employer percentage times the excluded compensation. The corrective amounts must also include lost earnings.

Review Employer Contributions

Employers must inform employees by November 2 of the employer contribution for the next year. The employer contribution can be 2% of all eligible employees' compensation, or up to a 3% matching contribution for participants who choose to make elective deferrals.

If the employer contribution is less than the amount required under the plan, the employer must make a corrective contribution. If there is an excess contribution due to elective deferrals, it can be distributed to the employees and reported on Form 1099-R as taxable income. If the excess is due to employer contributions, it can be distributed to the plan sponsor rather than the participants (they will still get Form 1099-R, but there will be no taxable income). The excess amounts can also be retained in the SIMPLE, but the plan sponsor must pay a special fee of 10% of the excess amount.



Observation Small Excess Amounts

If the total excess amount is \$100 or less, there is no requirement to distribute the excess, and there are no additional fees.

Check the Elective Deferral Deposit Dates

Employee elective deferrals must be deposited as soon as possible, but no later than 30 days following the month in which the deferrals were withheld. Plans that are subject to Department of Labor (DOL) rules require deposits as soon as the contributions can be separated from the employer's general assets. There is a 7-day safe

harbor period to make the deposits, and most SIMPLE plans qualify to use the safe harbor. The DOL deposit dates apply unless the plan is for the benefit of only an owner-employee and his or her spouse.

In general, the best practice is to make the deposit on the payroll date.

For self-employed persons with no common-law employees, the latest date for depositing salary reduction contributions is 30 days after the end of the calendar year (January 30).

Determine If There Are Terminated Participants Who Were Eligible to Participate

SIMPLE rules do not require that an employee still be employed on a particular day to receive matching or nonelective contributions. If an employee met the requirements to receive an employer contribution while still employed, the contribution is required even if the employee was fired, quit, or died. If a contribution was not made to an eligible terminated employee, the employer must make a correcting contribution.

Confirm That SIMPLE IRA Plan Notification Requirements Were Met

Before November 2 the employer should do the following:

- Give all eligible employees a written notice informing them of their right to make a salary deferral election for the next calendar year.
- If the plan allows the option, inform employees of their ability to select a financial institution for their SIMPLE IRA.
- Give a summary plan description to each participant.
- Notify employees of the employer's decision to make either a fixed or a matching contribution, and include the amount of the contribution or match.

401(k)

The 401(k) plan can be established either as a profit-sharing plan (PSP) or a money purchase

plan (MPP). Within those requirements, there are three basic types of 401(k) plans:

1. Traditional 401(k) plans: Eligible employees are allowed to make pretax deferrals through payroll deductions, and the employer can make contributions for all eligible employees, match the elective deferrals, or both. A vesting schedule can be used to require a period of time before the employer contributions are not forfeitable, or the employee can be immediately vested. The plan must meet the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test, which ensure that the 401(k) does not discriminate in favor of highly compensated employees. The employer can offer other plans in addition to the traditional 401(k).
2. Safe harbor 401(k) plans: The safe harbor plan is similar to the traditional plan, but employer contributions are fully vested when made, and the plan is not subject to the annual nondiscrimination tests.
3. SIMPLE 401(k) plans: Like the safe harbor plan, the SIMPLE 401(k) requires that employer contributions be fully vested when made, and there are no annual nondiscrimination tests. It is available only to employers with 100 or fewer employees who received at least \$5,000 in compensation from the employer in the preceding year. No other retirement plans can be offered to employees covered by a SIMPLE 401(k).



Practitioner Note

Solo 401(k)

A 401(k) plan that covers a business owner with no employees is a solo 401(k) plan. It has the same rules and requirements as a traditional 401(k) plan. See pages 26–31 in the *2014 National Income Tax Workbook* for a discussion of solo 401(k) plans.

Make Certain That the Plan Document Has Been Updated

According to Rev. Proc. 2007-44, 2007-2 C.B. 54, 401(k) plans must be amended and restated every 5 years for individually designed plans (6 years for preapproved plans). Interim amendments may be necessary if tax law changes.

Review Plan Operations for Consistency with Plan Terms

Plan operations have to follow the terms of the plan. The plan sponsor is responsible for keeping the plan in compliance with the tax laws, but there are others who provide services to the plan. Any changes made to the plan must be communicated to relevant parties, including tax practitioners, employees who contribute to the plan, employees who are responsible for nondiscrimination testing, and payroll department employees. Any change in company ownership must also be communicated to the plan sponsor.

Verify That the Plan Definition of Compensation Is Applied Correctly

The plan defines compensation for purposes of deferrals, contributions, and testing. Employers should review compensation definitions annually. The person responsible for determining compensation must be trained to understand the plan document and to apply the correct definitions for deferrals, contributions, and testing.

Examine Employer Matching Contributions

Employers should compare the matching contribution formula in the plan with the formula that was actually used, and should review the definition of compensation used to calculate the matching contributions.



Observation Payroll Term

If the plan documents define the match as a percentage of annual deferrals, and the payroll department makes the match every pay period, the match may be calculated erroneously. The employer has to apply reasonable correction methods to any affected employee accounts.

Perform the 401(k) ADP and ACP Nondiscrimination Tests

Five-percent company owners and employees receiving more than \$115,000 in the prior year (2014) are identified as highly compensated employees (HCEs). Employers should perform

an annual evaluation of the classifications of HCEs and non-highly compensated employees (NHCEs). There are two ways to avoid failure of the ADP and ACP nondiscrimination tests:

- Adopt a safe harbor plan that does not require nondiscrimination testing.
- Implement automatic enrollment procedures for all new hires.

Confirm That All Eligible Employees Were Given the Opportunity to Make an Elective Deferral

The plan document should have a definition of “employee” and should state when the employee is eligible to make elective deferrals. In general, if an employee receives a Form W-2, he or she is eligible to participate in the plan, unless there is a specific plan requirement that is not met. Eligible employees should receive a timely notice of their right to make an elective deferral.

Verify That Elective Deferrals Do Not Exceed the I.R.C. § 402(g) Limit

For a traditional or safe harbor plan, the limit on elective deferrals under I.R.C. § 402(g) is \$18,000 in 2015, plus an additional \$6,000 if the employee is age 50 or older. The total employee and employer contribution cannot exceed \$53,000, not including the catch-up elective deferrals.

The elective deferral limit for a SIMPLE 401(k) is \$12,500 in 2015, and the catch-up amount is \$3,000.

Check the Elective Deferral Deposit Dates

The Department of Labor requires that the employer deposit the elective deferrals to the plan trust as soon as the employer can segregate the deferrals from the employer’s general assets, but no later than the fifteenth day of the following month. There is a 7-business day safe harbor rule for companies with fewer than 100 participants. Failure to timely deposit deferrals may constitute a prohibited transaction, which is a transaction between a plan and a disqualified person (the employer). The disqualified person has to correct

the prohibited transaction and pay an excise tax based on the amount of the transaction. The tax is 15% of the amount involved in the prohibited transaction each year, and an uncorrected transaction can result in an additional tax of 100% of the amount involved.

In general, the best practice is to make the deposit on the payroll date.

Make Sure That Participant Loans Meet Requirements

Although many 401(k) plans permit loans to participants, plan sponsors should examine the plan documents to confirm that loans to participants are allowed. To prevent the loan from being treated as a taxable distribution under I.R.C. § 72(p), the following rules must be followed:

- The loan must be a legally enforceable agreement.
- The amount of the loan cannot be more than one-half of the participant's vested account balance up to a maximum of \$50,000. There is an exception that allows a participant to borrow a minimum of \$10,000.
- The terms of the loan should require level amortized payments at least quarterly, and the total amount must be repaid in 5 years, unless the loan is used to purchase the participant's primary residence.
- Repayments may be suspended for up to 1 year while the participant is on a leave of absence.



Practitioner Note

Military Service

Loan payments can be suspended for more than 1 year if the employee is performing military service. The repayment date is increased by the period of military service.

Determine If Hardship Distributions Were Made Properly

A plan may permit employees to receive a hardship distribution if there is an immediate and heavy financial need. The distribution is limited to the amount of the elective deferrals, without considering any income earned on the deferred

amounts. While the determination is made by the employer on a case-by-case basis, the following distributions are automatically considered to be made because of an employee's immediate and heavy financial need:

- Medical expenses for the employee, his or her spouse, or any dependents
- Costs directly related to the purchase of a principal residence (not including mortgage payments)
- Payment of tuition, related educational fees, and room and board for the next 12 months of postsecondary education for the employee and his or her spouse, children, or dependents
- Payments necessary to prevent the eviction of the employee from his or her principal residence, or payments to prevent a mortgage foreclosure on that residence
- Funeral expenses for the employee's deceased parent, spouse, or other relative
- Certain expenses to repair damage to the employee's personal residence



Observation

Abuse of Hardship Distributions

Signs that there may be an abuse of the program, or that the program is badly managed, include: too many requests by one group or division within the company, repetition of requests from multiple employees, and distributions that are made only to HCEs.

Assess Whether Top-Heavy Minimum Contributions Were Made

A plan is top-heavy if the total value of the plan accounts of key employees is more than 60% of the total value of the plan assets. If a plan is top-heavy, the employer must contribute up to 3% of compensation for all non-key employees still employed on the last day of the plan year. Key employees are any of the following:

- An officer who earns over \$170,000
- A 5% owner of the business (including the spouse, child, grandparent, or parent of

someone who is a 5% owner, or someone who, together with that individual, would own more than 5% of a company's stock)

- An employee who owns more than 1% of the business and earns over \$150,000 for the plan year

The top-heavy rules do not apply to SIMPLE 401(k) plans or to safe harbor plans.

Verify That Form 5500 Was Filed

Most 401(k) sponsors are required to file an annual Form 5500, Annual Return/Report of Employee Benefit Plan. Small employers whose employees are limited to owners or partners and their spouses must file Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan, for any year in which the year-end plan assets for all the employer's one-participant plans exceed \$250,000. Regardless of the plan asset value, all plan sponsors must file a final return for the year the plan is terminated and all assets are distributed.

Traditional and Roth IRA

The taxpayer is responsible for annual requirements of a traditional or a Roth IRA. The following issues should be addressed before December 31 of each year.

Check the Maximum IRA Contribution

No matter how many IRA accounts a taxpayer has, the total annual contribution amount is limited. This limitation for 2015 is \$5,500. Thus, a taxpayer with a traditional IRA and a Roth IRA may contribute a maximum of \$5,500 to the two accounts, divided in any manner that the taxpayer chooses. A taxpayer who is age 50 or older is allowed to contribute an additional amount to either type of IRA. For 2015 that additional amount is \$1,000.

Meet the Deadline for Making a Contribution

The contribution must be made by the original due date of the taxpayer's return. It cannot be extended.

Withdraw Any Excess Contribution

There is a 6% excise tax that is due each year that an excess contribution amount remains in the account. To avoid the tax, the excess amount must be withdrawn from the account by the due date of the return, including extensions.

Confirm That Required Minimum Distributions Were Timely Made

A taxpayer who is age 70½ or older must take a required minimum distribution (RMD) from the total amount of all traditional IRAs. There is no RMD for Roth IRAs. The distribution must usually be completed by December 31, but there is an exception for the year that the taxpayer turns 70½. For that first year the taxpayer can elect to take the first distribution by April 1 of the following year, and the taxpayer must take a second distribution before December 31. The taxpayer must take traditional IRA RMDs even if the taxpayer is still employed. If the taxpayer fails to timely take the RMD, the penalty can be as much as 50% of the RMD.



Cross-Reference

Penalty Abatement

See page 312 of the *2009 National Income Tax Workbook* for an illustration showing how to request a waiver of the penalty.



Practitioner Note

Inherited IRAs

Inherited IRAs do not follow the general rules. They cannot be rolled over, and they cannot be converted to Roth IRAs. RMDs for inherited IRAs have to be made separately from RMDs for other IRAs.

Required Minimum Distributions for Multiple Retirement Accounts

the total amount from one or more of the IRAs. RMDs from other types of qualified retirement plans, such as 401(k) plans, must be taken separately from each plan account.

IRA owners must calculate the RMD separately for each of their IRAs, but they can withdraw

ISSUE 2: FORM 1099-R This issue addresses general issues that arise in interpreting the information reported on Form 1099-R, plus additional substantiation requirements for rollovers and charitable contributions.

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Each person who received a distribution of \$10 or more from a retirement plan receives Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. This includes distributions from survivor income benefit plans, permanent and total disability payments from life insurance contracts, and charitable gift annuities. It also includes death benefit payments made by employers that are separate from a retirement

plan, and reportable disability payments made from a retirement plan.

A Form 1099-R is generally not required if the payments are tax exempt, such as workers' compensation or VA payments. However, if only part of the distribution is tax exempt, the entire amount is reported in box 1, and the taxable portion (if known) is reported in box 2a. **Figure 3.1** shows a Form 1099-R.

FIGURE 3.1 Form 1099-R

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, and ZIP or foreign postal code		1 Gross distribution		OMB No. 1545-0119		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
		\$ 2a Taxable amount		2015 Form 1099-R		
PAYER'S federal identification number		2b Taxable amount not determined <input type="checkbox"/>		Total distribution <input type="checkbox"/>		Copy B Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.
RECIPIENT'S identification number		3 Capital gain (included in box 2a)		4 Federal income tax withheld		
RECIPIENT'S name		5 Employee contributions /Designated Roth contributions or insurance premiums		6 Net unrealized appreciation in employer's securities		
Street address (including apt. no.)		7 Distribution code(s)		8 Other		
City or town, state or province, country, and ZIP or foreign postal code		9a Your percentage of total distribution %		9b Total employee contributions %		This information is being furnished to the Internal Revenue Service.
10 Amount allocable to IRR within 5 years		11 1st year of desig. Roth contrib.		12 State tax withheld		
\$		\$		\$		
Account number (see instructions)		15 Local tax withheld		16 Name of locality		
		\$		\$		17 Local distribution
		\$				\$

Form 1099-R

www.irs.gov/form1099r

Department of the Treasury - Internal Revenue Service

General Form 1099-R Issues

It is important to check Form 1099-R for miscalculations and to verify reported information.

Boxes 2a and 2b

Box 2a is the taxable amount. A zero in box 2a could indicate a direct rollover, an IRA recharacterization, or a nontaxable I.R.C. § 1035 exchange.

An “X” in box 2b indicates that the issuer is unable to reasonably obtain the data necessary to compute the taxable amount. Box 2b may be checked even if some distributions are obviously not all taxable. In some instances the issuer was not able to determine the taxable portion, perhaps because of the involvement of another provider, and the determination is left to the practitioner. In the case of Roth distributions and qualified contracts, many issuers automatically check box 2b, so the calculation must be done for the personal return.

Boxes 5, 6, and 8

Boxes 5, 6, and 8 provide the following amounts:

- Box 5 (“Employee contributions/Designated Roth contributions or insurance premiums”) is the amount that the employee can recover tax-free in the current year, even if the box 5 amount exceeds the box 1 amount.
- Box 6 (“Net unrealized appreciation in employer’s securities”) contains the net unrealized appreciation in the employer securities if there was a lump sum distribution, but only the portion attributable to employee contributions if there was not (see Issue 5 later in this chapter).
- Box 8 (“Other”) is the current actuarial value of an annuity contract that is part of a lump sum distribution.

The amounts in boxes 5 and 6 are included in box 1, but the box 8 amount is not included in box 1. None of these three amounts should be included in the box 2a amount.

Box 7

The box 7 distribution codes are summarized in **Figure 3.2**.



Cross-Reference

Nonqualified Annuities

A nonqualified annuity is identified on Form 1099-R by code 7D in box 7. See Issue 3 of this chapter.

Box 10

Box 10 shows the amount of a distribution that is allocable to an in-plan Roth rollover (IRR). An IRR is a distribution from an individual’s plan account that is rolled over to the individual’s designated Roth account in the same plan. The taxable amount must be included in the participant’s gross income and is defined as the amount that would be included in gross income if the rollover was made to a Roth IRA.



Observation

Was There a Distribution?

Taxpayers may not always bring Form 1099-R to their tax preparer. To determine whether a Form 1099-R was issued, the tax preparer should consider the age of the taxpayer, whether the taxpayer received a Form 8606, Nondeductible IRAs, and whether Form 1099-R was issued in prior years.



Cross-Reference

Limits on Rollovers

See pages 16–17 of the *2014 National Income Tax Workbook* for a discussion of the limitation on rollovers.

Specific Issues Involving Form 1099-R

Even if Form 1099-R is accurate, the IRS may require additional verification of reported amounts. There may be additional reporting or substantiation requirements for rollovers and charitable contributions.

FIGURE 3.2 Form 1099-R, Box 7, Distribution Codes

Code	Definition
1	Early distribution, no known exception (<i>in most cases, under age 59½</i>)
2	Early distribution, exception applies (<i>under age 59½</i>)
3	Disability
4	Death—regardless of the age of the employee/taxpayer
5	Prohibited transaction
6	Section 1035 exchange (<i>a tax-free exchange of life insurance, annuity, qualified long-term care insurance</i>)
7	Normal distribution
8	Excess contributions plus earnings/excess deferrals (<i>and/or earnings</i>) taxable in 2015
9	Cost of current life insurance protection
A	May be eligible for 10-year tax option
B	Designated Roth account distribution
D	Annuity payments from nonqualified annuities that may be subject to tax under I.R.C. § 1411
E	Distributions under Employee Plan Compliance Resolution System (EPCRS)
F	Charitable gift annuity
G	Direct rollover of a distribution (<i>other than a designated Roth account distribution</i>) to a qualified plan, a section 403(b) plan, a governmental section 457(b) plan, or an IRA
H	Direct rollover of a designated Roth account distribution to a Roth IRA
J	Early distribution from a Roth IRA, no known exception (<i>in most cases, under age 59½</i>)
L	Loans treated as distributions
N	Recharacterized IRA contribution made for 2015 and recharacterized in 2015
P	Excess contributions plus earnings/excess deferrals (<i>and/or earnings</i>) taxable in 2015
Q	Qualified distribution from a Roth IRA
R	Recharacterized IRA contribution made for 2015 and recharacterized in 2016
S	Early distribution from a SIMPLE IRA in first 2 years, no known exception (<i>under age 59½</i>)
T	Roth IRA distribution, exception applies
U	Dividend distribution from ESOP under I.R.C. § 404(k)
W	Charges or payments for purchasing qualified long-term care insurance contracts under combined arrangements

Proving a Rollover

A direct rollover is reported on Form 1099-R by reporting a gross distribution in box 1, a zero taxable amount in box 2a, and code G in box 7. The IRS, however, requires one further step to verify the rollover. When the rollover amount is received by the new provider, the new provider must submit a Form 5498, IRA Contribution Information, to the IRS. The Form 5498 due date is May 31 of each calendar year, to enable the taxpayer to have time to make contributions up to and including April 15 for the prior year. This means that the taxpayer may not have

received Form 5498 before the return is filed. Box 2 of Form 5498 should contain the same dollar amount as shown in box 1 on Form 1099-R. **Figure 3.3** shows a Form 5498.

If the Form 5498 is not submitted, the IRS will likely send a letter asking the taxpayer to verify that the rollover meets the requirements to be nontaxable. Taxpayers should maintain the following records, which can serve as documentation of the rollover transaction:

- A copy of the deposit verification from the new provider

FIGURE 3.3 Form 5498

☐ CORRECTED (if checked)

TRUSTEE'S or ISSUER'S name, street address, city or town, state or province, country, and ZIP or foreign postal code		1 IRA contributions (other than amounts in boxes 2-4, 8-10, 13a, and 14a)	OMB No. 1545-0747 2015 Form 5498		IRA Contribution Information
		2 Rollover contributions			
				3 Roth IRA conversion amount	
TRUSTEE'S or ISSUER'S federal identification no.	PARTICIPANT'S social security number	5 Fair market value of account	6 Life insurance cost included in box 1	For Participant	
PARTICIPANT'S name		7 IRA <input type="checkbox"/> SEP <input type="checkbox"/> SIMPLE <input type="checkbox"/> Roth IRA <input type="checkbox"/>	This information is being furnished to the Internal Revenue Service.		
Street address (including apt. no.)		8 SEP contributions	9 SIMPLE contributions		
City or town, state or province, country, and ZIP or foreign postal code		10 Roth IRA contributions	11 If checked, required minimum distribution for 2016 <input type="checkbox"/>		
		12a RMD date	12b RMD amount		
		13a Postponed contribution	13b Year	13c Code	
		14a Repayments	14b Code		
Account number (see instructions)		15a FMV of certain specified assets	15b Code(s)		

Form **5498** (keep for your records) www.irs.gov/form5498 Department of the Treasury - Internal Revenue Service

- A copy of the account statement during the period of the transfer
- A statement from the original provider that the amount in question was directly rolled over to the new account
- The taxpayer's copy of the Form 5498, in the event that the IRS did not receive a copy



Practitioner Note Follow-Up Conversion

A letter from the IRS occurs more frequently if the taxpayer made a follow-up conversion after recharacterizing an earlier conversion. Filing Form 8606, Nondeductible IRAs, may ward off the mismatch that causes the IRS to send the letter.

Charitable Contributions

Qualified charitable donations from an IRA were allowed through December 31, 2014. Individuals age 70½ or over could exclude up to \$100,000 from gross income for IRA distributions paid directly to a qualified charity. In the case of

married couples filing jointly, each was allowed to exclude up to \$100,000. The qualified charitable donation (QCD) satisfied any RMD for the year and did not qualify as an itemized charitable deduction. The QCD was reported on Form 1099-R, and the taxpayer reported the full amount of the distribution on Form 1040, line 15a, or Form 1040A, line 11a. The letters "QCD" were entered on either line 15b or 11b, and the taxable amount of the distribution was shown as zero.

The taxpayer, not the IRA trustee, must verify that the charity qualifies, that the taxpayer qualifies, and that the distribution meets all of the requirements of a QCD. If the IRS fails to notice the QCD and declares that it is a regular distribution, the taxpayer must substantiate the QCD. In order to qualify as a QCD, the donation must be by check from the IRA to the qualified charity, so a copy of the IRA account record should show the transaction. Hand delivery of the check to the charity is acceptable as long as the check is made payable to the charitable organization. If the taxpayer instead takes the money out of the IRA and then writes a check to charity, there is a taxable distribution and a charitable contribution

deduction. Depending upon the taxpayer's other income, he or she may not get the full benefit of the charitable deduction to apply against the distribution. If the taxpayer lives in a state that does not allow itemized deductions, there is no offset against the distribution on the state income tax return. The receiving charity should issue a receipt for the donation, which also provides verification of the QCD.

The QCD rules apply only to IRA assets that would otherwise be taxable. Only the pretax portion of the IRA can be used for the QCD. Only the earnings portion of a Roth IRA is eligible for

the QCD (and can be withdrawn before principal for this purpose).

The QCD has expired and been reinstated several times. On December 19, 2014, the QCD was reinstated through 2014. As of this writing, it is expired.



Cross-Reference

Qualified Charitable Donation Extension

If the QCD is extended prior to publication of this book, the extension will be noted in the "New Legislation" chapter.

3

ISSUE 3: NONQUALIFIED ANNUITIES This issue defines nonqualified annuities, discusses their general tax treatment, and reviews specific tax issues related to early distributions and exchanges.

While qualified annuities may be offered by an employer plan, a nonqualified annuity is purchased by an individual through a third-party issuer such as an insurance company. Unlike a pension, which is a series of payments made for past services with an employer, an annuity is a series of payments made under a contract. The payments, whether from a qualified or nonqualified annuity, can be made in a variety of ways.

- Fixed period annuities provide specified amounts at regular intervals for a definite length of time.
- Single life annuities provide definite amounts at regular intervals for life. When the individual dies, the payments end.
- Joint and survivor annuities provide a definite amount at regular intervals for the life of the first annuitant. After the death of the first annuitant, the survivor receives a definite amount at regular intervals for life. The amount received by the surviving annuitant is not always the same as the amount received by the first annuitant.
- Variable annuities provide payments that may vary in amount for either a definite length of time or for life.

No matter which type of annuity is involved, each monthly payment consists of two parts: a

tax-free part that is a return of the net cost, and the taxable balance.

If an annuity is part of an IRA or qualified retirement plan, it is a qualified annuity. Because of the restrictions on qualified plans, contributions to a qualified annuity are limited by the amount of income received. If an annuity is purchased outside a qualified plan or IRA, it is nonqualified, and there are no restrictions on the amount of contributions to the annuity. There are no deductions for contributions to a nonqualified annuity, and there is no taxable income until there is a distribution. A nonqualified annuity distribution is identified on Form 1099-R by code 7D in box 7.



Observation

Trading Investment Property for an Annuity

Purchasing a nonqualified annuity is quite different from exchanging investment property for an annuity. In the latter case the transaction is taxable. If the present value of the annuity is more than the basis in the property traded, the excess is a taxable gain in the year of the transaction.

**Practitioner
Note****Net Investment
Income Tax**

Distributions from a nonqualified annuity are considered net investment income and may be subject to the net investment income tax (NIIT).

Taxing Distributions

There are two ways to take distributions from a nonqualified annuity: withdrawals or annuitization.

Withdrawals

When an annuitant makes a withdrawal, it is taxed as gain first, then basis. The gain is ordinary income, and the basis is tax-free. There is an exception to the ordering rules for an annuity purchased prior to August 14, 1982—the basis comes out first.

Example 3.1 Taxing a Distribution

Leo Lopez invested \$100,000 in an annuity 10 years ago. Today it is valued at \$150,000. If Leo takes a \$60,000 distribution, the first \$50,000 (\$150,000 – \$100,000) is taxable ordinary income, and the remaining \$10,000 is a tax-free return of basis. The \$50,000 taxable portion will be reported on a Form 1099-R. There is no gain remaining in his annuity after this transaction, although the future earnings will become taxable gain (ordinary income).

Annuitization

Instead of making a withdrawal, the annuitant can elect to annuitize the contract, which changes the cash value of the annuity into an income source. The annuitization can last for life or for a chosen period of time. Each payment has a taxable portion and a return of basis.

Example 3.2 Taxing an Annuitization

Leo, in Example 3.1, chooses to annuitize his contract over a period of 10 years. The insurance company guarantees an \$18,200 annual payment. The first \$10,000 (\$100,000 ÷ 10 years) of each payment is tax free, and \$8,200 (\$18,200 – \$10,000) is taxed as ordinary income.

Guaranteed Withdrawal Benefits

Annuitants can purchase an option to protect their investments with a guaranteed annual withdrawal percentage. If the value of the annuity is less than the original purchase price, the annuitant can still make annual withdrawals up to the original cost. For example, if a \$100,000 investment is now worth \$90,000, and the annuitant purchased a 10% guaranteed withdrawal, the annuitant can take out 10% of the current value of the annuity annually until the initial \$100,000 investment is recovered. The withdrawals are nontaxable basis recoveries up to the \$100,000 original investment. Any amounts in excess of this investment are taxed as ordinary income.

Inherited Nonqualified Annuities

If the beneficiary is the spouse of the annuitant, he or she may be able to continue the policy without tax consequences if the death benefit is paid into the policy. Other companies offer the option to receive either the death benefit or spousal continuation. Choosing the death benefit results in a taxable consequence on the difference between it and the amount invested, adjusted for withdrawals, and is treated as ordinary income.

In the case of a nonspouse beneficiary, the difference between the death benefit and the investment, as adjusted for withdrawals, is taxable to the beneficiary as ordinary income. There is no step-up in basis. They may, however, have the option to make an I.R.C. § 1035 exchange, discussed later in this chapter.

General Rule for Taxation of Nonqualified Annuities

Nonqualified annuity distributions are taxed using the general rule, which requires that the part of each annuity payment that represents the net cost is in the same proportion that the investment in the contract is to the expected return. These terms are defined below.

Investment in the Contract

To determine investment in the contract, the taxpayer must first calculate the net cost. The net cost is the total cost plus certain adjustments, and minus amounts that are recovered prior to the

annuity starting date. The net cost is the unrecovered investment in the contract as of the annuity starting date. If the annuity starting date is after 1986, net cost is also the maximum amount that can be recovered tax-free.

To determine the net cost, first calculate total cost, which is the total premiums, contributions, or other amounts paid. From the total cost, subtract any refunded amounts received by the later of the annuity starting date or the date on which the first payment was received to arrive at the net cost.

Foreign employment

If the owner worked abroad and the employer contributed to the retirement plan, an addition to the total cost may be required. Contributions are an allowable part of the total cost only if the contributions would have been excluded from gross income if paid directly as compensation. The included contributions are the following:

- Employer contributions before 1963
- Employer contributions after 1962 if the contributions would be excluded from gross income if paid directly to the employee (without regard to the foreign earned income exclusion)
- Employer contributions after 1996 on behalf of person working as a foreign missionary (duly ordained, commissioned, or licensed minister of a church or a layperson) if the contributions would be excluded from gross income if paid directly to the employee

Death Benefit

There used to be a death benefit exclusion for the beneficiary of a deceased employee, but that exclusion is not available if the employee died after August 20, 1996.

Refund Feature

If an annuity has a refund feature, net cost is reduced by the value of the refund feature. A refund feature is present if

- the expected return depends upon the life of one or more people;
- the contract requires continued payments until a stated amount is paid or a stated

number of payments are made, even if the annuitant dies earlier; or

- the payments are a refund of the cost of the contract.

The value of the refund feature is zero if it is a joint and survivor annuity and both annuitants are age 74 or younger, the payments are guaranteed for less than 2½ years, and the survivor's annuity is at least 50% of the first annuitant's annuity. In the case of a single life annuity without a survivor benefit, there is no value to the refund feature if the payments are guaranteed for less than 2½ years and the annuitant is

- age 57 or younger if using the new unisex tables,
- age 42 or younger if male and using the old annuity tables, or
- age 47 or younger if female and using the old annuity tables.

If the requirements of the preceding paragraph are not met, the actuarial tables in Publication 939, *General Rule for Pensions and Annuities*, are required to calculate the value of the refund feature.

Actuarial Tables

The actuarial tables are used if the annuitant is receiving payments for life, as opposed to payments for a fixed number of years. In general, Tables V through VIII must be used if contributions were made to the retirement plan after June 30, 1986. These tables are calculated using a unisex formula, and there are not separate tables for men and women, as in Tables I through IV.

If contributions were made before and after June 30, 1986, an election allows separate calculations using the appropriate tables for each time period. Although the computation may be difficult because of the lack of available information, the election could result in a lesser tax on the annuity payments.

To make the election, the taxpayer has to attach the following statement to the income tax return for the first year in which a payment is received: "I elect to apply the provisions of paragraph (d) of section 1.72-6 of the Income Tax Regulations." The statement must also include the taxpayer's name, address, social security number, and the amount of the pre-July 1986 investment.

Formula for Refund Value

The worksheet for calculating the value of a refund feature and the investment in the contract is illustrated in Examples 3.3 and 3.4.

Example 3.3 Guaranteed Amount Equals Investment

Micah Moore bought an annuity at the age of 64. He paid \$48,000 and will receive \$175 per month for the rest of his life. Micah specified that

he wanted to recover his full investment, so, if he dies before he has recovered the entire \$48,000, his niece Millie will receive the \$175 a month until a total of \$48,000 has been paid. His investment in the contract, taking into account the refund feature, is \$37,920, as calculated in **Figure 3.4**.

FIGURE 3.4 Investment in Contract: Guaranteed Amount Equals Investment

1. Net cost	\$48,000
2. Amount to be received annually (\$175 × 12 months)	\$2,100
3. Number of years for which the payment is guaranteed (total guaranteed return ÷ line 2) (\$48,000 ÷ \$2,100)	22.86
4. Round line 3 to nearest whole number in years	23
5. Percentage from Actuarial Table VII for age 64 and 23 years	21%
6. Value of refund feature (total guaranteed return × line 5) (\$48,000 × 21%) (rounded to nearest dollar)	10,080
7. Investment in the contract as adjusted for refund feature (line 1 minus line 6)	\$37,920

Example 3.4 Guaranteed Amount Is Less than Investment

Using the facts in Example 3.3, if Micah had requested a 20-year contract guarantee instead of recovering his full investment, his guaranteed return is \$42,000 (\$2,100 per year × 20 years). His investment in the contract, taking into account the refund feature, is \$40,860, as calculated in **Figure 3.5**.

FIGURE 3.5 Investment in Contract: Guaranteed Amount Is Less Than Investment

1. Net cost	\$48,000
2. Number of years for which the payment is guaranteed	20
3. Percentage from Actuarial Table VII for age 64 and 20 years	17%
4. Value of refund feature (total guaranteed return × line 3) (\$42,000 × 17%) (rounded to nearest dollar)	7,140
5. Investment in the contract as adjusted for refund feature (line 1 minus line 4)	\$40,860

Expected Return

The expected return from an annuity contract depends upon the annuitant's age at the birthday nearest to the annuity starting date, and the type of annuity.

Fixed Period Annuity

The life expectancy of the annuitant is not a factor, so the actuarial tables are not required. The expected return is the payment amount times the guaranteed number of payments. If the guarantee is \$500 per month for 60 months, the expected return is \$30,000 ($\500×60). If the guarantee is \$3,000 per year for 12 years, the expected return is \$36,000 ($\$3,000 \times 12$).

Single Life Annuity

If the contributions were all made to a single life annuity after June 30, 1986, use Table V (otherwise use Table I). The expected return is the annual payment times the multiple shown in Table V for the appropriate age.

Example 3.5 Single Life Annuity

Elsa Alvarez bought an annuity contract guaranteeing her \$700 per month for the rest of her life. She was 65 years old when her payments actually began. Her expected return is \$168,000, which is the \$8,400 ($\$700 \times 12$) annual payment multiplied by the Table V multiple of 20 for age 65. If Elsa's payments were made quarterly instead of monthly, there is an adjustment chart at the end of Table I in Publication 939. In order to use it, the practitioner must know the annuity starting date and the number of full months before the first payment is made. If there is a 1-month delay, the multiple should be increased by 0.1; if there is a 3-month delay, the multiple should be decreased by 0.1. No adjustment is required for any other delays. In this case a 3-month delay decreases the multiple from 20 to 19.9, and the expected return decreases to \$167,160 ($\$8,400 \times 19.9$). Adjustments are also required for annual and semiannual payments.

Annuity for the Shorter of Life or a Specified Period

An annuity for the shorter of life or a specified period is also known as a temporary life annuity.

The annuitant receives a lifetime annuity or payments for a specific number of years, whichever period is shorter. Table VIII (or Table IV) is used to calculate the expected return.

Example 3.6 Temporary Life Annuity

Rosie Richards purchased an annuity that pays \$500 per month for 10 years or until death, whichever is sooner. If Rosie was age 62 at the annuity starting date, the multiple is 9.5, and the expected return is \$57,000 ($\$500 \times 12 \text{ months} \times 9.5$). If Rosie is still living in 10 years, the annuity terminates. If she dies before she reaches age 72, the annuity terminates.

Joint and Survivor Annuities

If the first annuitant and the survivor receive the same amount, the expected return is based on their combined life expectancies. The expected return is the annual payment multiplied by the multiple in Table VI (or Table II). The ages of the first annuitant and the survivor are both required to determine the multiple. The multiple has to be adjusted if the payments are made quarterly, semiannually, or annually instead of monthly.

Example 3.7 Same Payment for Joint and Survivor

Andrew Alexander purchased a joint and survivor annuity, which pays him \$600 per month for the rest of his life. After his death, his wife, Antonia, will continue to receive the \$600 per month until she dies. At the annuity starting date, Andrew is 70 and Antonia is 65. The multiple shown in Table VI for ages 70 and 65 is 23.1. The annual payment is \$7,200 ($\$600 \times 12 \text{ months}$), which is multiplied by 23.1, resulting in an expected return of \$166,320.

Example 3.8 Different Payments for Joint and Survivor

Using the facts in Example 3.7, if Andrew receives \$600 per month for the rest of his life, but Antonia will receive only \$500 per month after his death, the \$157,800 total expected return is calculated as shown in **Figure 3.6**.

FIGURE 3.6 Total Expected Return: Different Payments

Combined multiple from Table V	23.1	
Multiple for Andrew (Table V)	(16.0)	
Difference (Antonia's portion)	<u>7.1</u>	
Andrew's annual payment ($\$600 \times 12$)	\$7,200	
Multiple for Andrew	<u>$\times 16$</u>	
Andrew's expected return		\$115,200
Antonia's annual payment ($\$500 \times 12$)	\$6,000	
Antonia's multiple	<u>$\times 7.1$</u>	
Antonia's expected return		<u>\$ 42,600</u>
Total expected return		<u><u>\$157,800</u></u>

Computation of the Taxable Part of an Annuity

The following steps compute the tax-free and taxable portions of annuity payments under the General Rule. They are not used for variable annuities, which are discussed later in this section.

Step 1. Figure the adjusted investment in the contract.

Step 2. Figure the expected return.

Step 3. Divide Step 1 by Step 2 and round to three decimal places. This is the exclusion percentage.

Step 4. Multiply the exclusion percentage by the first regular periodic payment. This is the tax-free portion of each payment. The amount does not change even if the payments change.

Step 5. Multiply the tax-free part of each payment (Step 4) by the number of payments received for the year. This is the tax-free part of the total payment for the year.

Step 6. Subtract the tax-free part from the total payment received for the year; the remaining amount is taxable for the year.

Example 3.9 Figuring the Tax-Free Amount

Millie Miller began receiving payments from her single life annuity in March 2015. She is 66 years old. The adjusted investment in the contract is \$75,000. Her expected return, based on payments of \$600 per month, is \$138,240 ($\$600 \times 12$

$\times 19.2$ Table V multiple for age 66). Her exclusion percentage is 0.543 ($\$75,000 \div \$138,240$). If Millie received 10 payments of \$600 each in 2015, \$325.80 ($0.543 \times \$600$) of each payment is tax-free. Her tax-free total is \$3,258 ($\325.80×10). The remaining \$2,742 ($\$6,000 - \$3,258$) is taxable as ordinary income. If Millie received a 3.5% cost-of-living increase in 2016 and her monthly payment increased, her tax-free amount does not change, and any additional money paid to her by the annuity is taxable as ordinary income. However, if Millie's annuity has scheduled increases on known dates, those increases must be taken into account in calculating the expected return for the annuity.

Exclusion Limits

If the annuity starting date is after 1986, the amount of annuity income that can be excluded is limited to the net cost of the annuity. The refund feature is not a part of the net cost calculation. If the cost is not recovered before the death of the annuitant (or last survivor), it is allowed as a miscellaneous itemized deduction on the final return of the decedent, and is not subject to the 2% of adjusted gross income floor.

Annuities with starting dates prior to 1987 can continue to take the monthly exclusion for as long as the annuity payments are received by the annuitant or by a survivor. This may result in

the total exclusion exceeding the investment in the contract.

Variable Annuities

The tax-free portion of a variable annuity is calculated by dividing the investment in the contract (as adjusted for a refund feature) by the total number of payments expected under the contract. If the annuity is for a definite period, the number of payments equals the number of payments made each year multiplied by the guaranteed number of years. Calculation of the tax-free portion of a life annuity requires a multiple from the appropriate actuarial table.

Example 3.10 Tax-Free Portion of Variable Annuities

Martin McGee purchased a variable annuity at age 60. The starting date was January 1, 2015, and he received his first payment July 1, 2015. He will receive annual payments for a guaranteed 10 years, but the payments will vary from year to year. His investment in the contract is \$10,000. Martin's tax-free amount is \$1,000 each year (\$10,000 investment ÷ 10 years of annual payments). If instead Martin receives the annual payments over his lifetime, the tax-free annual portion is \$413, which is the \$10,000 investment divided by 24.2 (the Table V multiple for age 60).

Example 3.11 Refiguring the Tax-Free Portion

Using the facts in Example 3.10, if Martin receives annual payments over his lifetime, and his current-year payment is \$200, none of the payment is taxable because the \$413 tax-free portion is more than the actual amount received. Martin can elect to recalculate the tax-free amount when he receives the next payment. If Martin receives \$700 the next year (at age 62), he can recalculate the tax-free portion, which would then be used for the remaining years. The recalculated tax-free portion is \$422.47, as shown in **Figure 3.7**.

FIGURE 3.7 Recalculated Tax-Free Portion

1. New payment	\$700.00
2. Amount tax-free in prior year	\$413.00
3. Amount received in prior year	(200.00)
4. Difference (line 2 – line 3)	\$213.00
5. Table V multiple for age 62	22.5
6. Increase in tax-free amount (line 4 ÷ line 5)	\$ 9.47
7. New tax-free amount (line 2 + line 6)	422.47
8. Taxable amount (line 1 – line 7)	\$277.53

Other Plans Required to Use the General Rule

Most qualified plans can use the Simplified Method, which is discussed in Publication 575, *Pension and Annuity Income*. A qualified plan is required to use the General Rule if

- the annuity starting date is before November 19, 1996 (and after July 1, 1986), and the annuitant did not qualify to use the Simplified Method or did not choose to use it; or
- the annuity starting date is after November 18, 1996, and as of that date the annuitant is age 75 or over and the annuity payments are guaranteed for at least 5 years.

Nonqualified Annuity Special Tax Issues

If there is no applicable exception, early distributions from a nonqualified annuity are subject to a penalty. An exchange of an annuity may qualify as a tax-free exchange.

Early Withdrawal Penalty

There is a 10% penalty for distributions taken from a nonqualified annuity before age 59½. There are three general exceptions to the penalty that apply to all early pension and annuity distributions, whether qualified or not:

1. Substantially equal periodic payments over the life expectancy of the owner/plan participant
2. Total and permanent disability
3. Death of the owner/plan participant

In addition, there are four other exceptions specifically for early distributions from a non-qualified annuity:

1. Distributions from a deferred annuity contract that are allocable to either the cost or basis portion of a deferred annuity contract issued before August 14, 1982
2. Distributions paid from a deferred annuity contract under a qualified personal injury settlement
3. Distributions paid under a deferred annuity contract purchased by an employer on the termination of a qualified employee retirement plan or qualified annuity, which is held by the employer until the taxpayer separates from the service of the employer
4. Distributions paid under an immediate annuity contract as defined in I.R.C. § 72(u)(4), which are annuities
 - a. purchased with a single premium or annuity consideration,
 - b. with an annuity starting date that commences no later than 1 year from the date of the purchase of the annuity, and
 - c. that provide for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period

Example 3.12 Immediate Annuity Contract

Susan Stone purchased a \$250,000 annuity on February 15, 2015, with the proceeds from the sale of her house. She will start receiving annual payments on January 1, 2016, and the payments will continue for 15 years. Susan is 56 years old. Susan's purchase qualifies as an immediate annuity contract because it was purchased with a single premium, the payments begin within a year, and the payments are substantially equal over the 15-year annuity period. Early distributions are not subject to the 10% penalty because they are distributions paid under an immediate annuity contract.

Example 3.13 Exchange of Deferred Annuity

Susan Stone from Example 3.12 instead purchased the annuity by exchanging a deferred annuity contract she purchased on June 1, 2013, for the new annuity contract. She does not meet the requirements for an exception from the 10% penalty because pursuant to Rev. Rul. 92-95, 1992-2 C.B. 43, the deemed purchase date of the new annuity contract is the date she purchased the original contract. Because the annuity payouts will not begin within a year of the June 1, 2013, deemed purchase date, the new contract is not an immediate annuity. There are no applicable exceptions, and Susan owes the 10% penalty on an early distribution.

Example 3.14 Purchase of a Deferred Annuity after Cancellation of Qualified Plan

Susan Stone's employer from Example 3.12 purchased a deferred annuity after the cancellation of the employer's qualified plan. If the employer had control of the annuity, Susan left the company, and then she began receiving distributions, early distributions are exempt from the 10% penalty.

Section 1035 Exchange

If a taxpayer purchased a nonqualified annuity but is not satisfied with the investment, there are potential tax consequences if the annuity is sold (cashed in). Gain that has accumulated in the annuity is taxable when the annuity is sold. It is, however, possible to exchange the annuity for a different annuity without any tax consequences. In order to qualify as a tax-free exchange, the annuity exchange must be handled completely by the companies involved.

Titling the Account

The annuitant on the new contract must be exactly the same as the annuitant on the old contract. However, the new contract can be adjusted at a later date if, for example, the taxpayer wants to change from a single owner to joint ownership.

Multiple Contracts

If the annuitant owns several different contracts and wishes to exchange them for a single one,

there are no limits on the number of contracts that can be exchanged if the ownership remains consistent.

Partial Exchange

Pursuant to I.R.C. § 72(a)(2), if any amount is received as an annuity for 10 years or more, or during one or more lives under any portion of an annuity, endowment, or life insurance contract, then

1. that portion is treated as a separate contract for purposes of I.R.C. § 72,
2. the investment in the contract is generally allocated pro rata between the portion of the contract from which amounts are received as an annuity and the portion from which amounts are not so received, and
3. a separate annuity starting date is determined with respect to each portion of the contract from which amounts are received as an annuity.

If the exchange does not meet the 10-year rule but there is a partial exchange, no surrenders or withdrawals from either annuity are permitted within 180 days of the exchange.

To calculate the basis for the partial exchange annuities, the cost of the original annuity is allocated between the old and the new annuities

based on the percentage of value in the old annuity and the percentage of value transferred to the new annuity. If the exchange is done correctly, the contracts will not have to be aggregated for either tax treatment or distributions, even if there is only one insurance company involved.

Once the basis is known, the amount allocable to income is the excess of the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over the investment in the contract at that time.

Example 3.15 Partial Exchange

James Jackson purchased an annuity contract for \$22,000. The cash surrender value of the contract is now \$25,000. If James withdraws \$2,000 from the annuity contract, the entire \$2,000 is taxable because it is treated as a fully taxable distribution. If instead James assigned one-half of the cash surrender value (\$12,500) in a partial exchange, the cash surrender value of each contract is now \$12,500, and the basis of each contract is \$11,000. If James closes out either contract, his \$11,000 basis would not be taxed, so he would owe tax on only the remaining \$1,500. However, if James completes the partial exchange and withdraws \$2,000, the withdrawal is still treated as a fully taxable distribution.

3

ISSUE 4: REVERSE MORTGAGES This issue explains how reverse mortgages work, who can qualify for a reverse mortgage, and what questions to consider before applying for a reverse mortgage.

A reverse mortgage allows seniors the opportunity to remain in their homes while receiving the built-up equity as cash. The homeowner takes out a mortgage against part of the equity in the home, and the lender pays the homeowner. Title to the home does not change. The money received is not taxable in most circumstances, and it does not affect social security or Medicare benefits. Repayment of the loan is required in the following circumstances:

- If the owner sells the house, the owner is responsible for repaying the loan.
- If the owner dies, the spouse or estate is responsible for repaying the loan.

- If the owner moves out for a period of 12 months without selling the house, the owner is responsible for repaying the loan.

Types of Reverse Mortgages

The three types of reverse mortgages are single-purpose reverse mortgages, private loans, and federally insured reverse mortgages.

Single-Purpose

The single-purpose reverse mortgage is the least expensive of the three types, but it is not available

everywhere. This type of mortgage is offered by state and local government agencies or by non-profit organizations. The lender specifies how the loan proceeds can be used; examples include home repairs, improvements, or property taxes.

Private Loans

Also called proprietary reverse mortgages, private loans are backed by the companies that offer them. If the borrower has a higher-valued home, he or she may be able to borrow more money with a proprietary reverse mortgage.

Federally Insured

The Home Equity Conversion Mortgage (HECM) is backed by the US Department of Housing and Urban Development (HUD) and can be used for any purpose. The amount the borrower can receive is limited to the least of:

1. the appraised value,
2. the \$625,000 HECM FHA mortgage limit, or
3. the purchase price, if the HECM is a purchase loan.

Qualifications

Both the home and the owner must meet certain qualifications to qualify for an HECM reverse mortgage.

Home

The following types of properties are eligible for an HECM reverse mortgage.

1. Single-family homes
2. 2- to 4-unit properties
3. Manufactured homes built after June 1976 and titled and taxed as real property under state law
4. Condominiums (almost always an apartment within a complex that is privately owned; the rest of the connecting areas are communally owned by all the condominium residents)
5. Townhouses (adjacent houses sharing one or two walls)



Observation Co-ops

Housing cooperatives are legal entities that own real estate. The co-op grants its shareholders the right to occupy a housing unit. The cooperative can be either equity, in which there is a purchase agreement, or nonequity, in which equity rights are in the form of a lease. Participation in an equity or a nonequity co-op does not qualify for a reverse mortgage.

Owner

The borrower must be 62 years of age, and the home must be his or her principal place of residence. The amount of equity must also meet certain requirements; in general, the higher the equity, the more funding is available. In addition, anyone applying for a loan from an HECM (or some private lenders) must first undergo counseling from an independent HUD-approved agency. Because the owner will continue to be responsible for the maintenance of the home and the taxes and insurance, the owner has to confirm his or her financial ability to pay those expenses.

Joint Owners

The requirement that loan signers had to be 62 years old created problems for surviving spouses whose names were not on the loan. The death of the borrower caused the loan to come due, and the survivor could not pay off the loan. As a result the survivor faced foreclosure proceedings. HUD rules (affecting all HECMs) effective August 4, 2014, allow the survivor to continue living in the home as long as he or she continues to maintain the home and pay the taxes and insurance. If the lender was making regular payments to the now-deceased owner, those payments will stop.

Under the prior rules, the amount that could be borrowed was based on the age of the older spouse, which allowed a larger loan amount. Pursuant to the August 4, 2014, HUD rules, the amount that can be borrowed is now based on the younger spouse's age, even if that spouse is not a borrower.

Financial Considerations

The tax and financial impact of a reverse mortgage should be part of the pre-loan evaluation. The following are key considerations:

1. It is not inexpensive to take out a reverse mortgage. Depending on the type of loan, the costs can include origination fees and other closing costs and servicing fees. There may even be a requirement to pay mortgage insurance premiums (most often on HECMs).
2. As the lender provides funding, a loan balance is created, and interest is added to that balance each month. Currently, interest rates are relatively low, but an increase in rates can produce a much larger payback requirement. Potential borrowers should also be aware that there are not typically installment payments on the loan, but rather a payoff of the total amount due. Many times the house will have to be sold in order to pay the liability.
3. Interest accrues every month, but there are no deductions for that interest until the loan is paid off. The deduction is subject to the \$100,000 home equity debt limit.
4. Borrowers are still responsible for the maintenance of the property. Lenders may require a certain set-aside amount, which lowers the amount that can be paid to the borrower, to cover the cost of insurance and taxes. If the borrower fails to maintain the property or to keep up with the financial obligations, the lender can require repayment of the loan.
5. Most reverse mortgages contain a nonrecourse clause, which means that the owner or the owner's estate cannot owe more than the value of the home when the loan becomes due. If the heirs want to pay off the loan and keep the house, their maximum payment is the appraised value of the home.

Questions and Answers

Question 1.

Ava Arnez is 82 years old. She has a small amount of social security income and owns a 35-year-old manufactured home. She needs to make some significant home repairs, but she does not have

the money for the repairs. A local contractor suggested she could finance the repairs through a reverse mortgage. Does this make sense for Ava?

Answer 1.

No. Ava's first step should be the local Area Agency on Aging, which might be able to suggest programs in her area that provide loan or grant programs for home repairs. Ava's only recourse through a reverse mortgage is a single-purpose lender, but that may not be the best answer for her either. She does not want to take the advice of the contractor, who most likely has his own interests at heart. Does Ava have children who could help with this situation? What is the state of her health? How much longer is she likely to be living in her house? A reverse mortgage is seldom the first and best choice.

Question 2.

Mary Meek is 85 years old, and her daughter Minnie is 61. Mary took out a reverse mortgage 2 years ago to provide some additional monthly income. Now Mary's health is not good, and Minnie is moving in with her to help out. Minnie would like to own her mother's house. Can she take over the reverse mortgage next year when she turns 62?

Answer 2.

No. A reverse mortgage cannot be assumed. As long as the reverse mortgage is in place, the interest and the liability continue to grow. Mary cannot gift the house to Minnie because she would no longer be the owner, and the loan would come due. If Minnie waits until Mary dies, Mary's estate will have to pay off the loan. If Minnie buys the house from her mother, her mother can pay off the debt and still stay in the house with Minnie. There are several options, each of which needs to be analyzed from a financial perspective.

Question 3.

Jeff Jackson took out a reverse mortgage 10 years ago. It has paid him a monthly amount for 10 years and accrued interest at a 7% rate. Jeff was moved to an assisted living facility and no longer lives in the house. The house sold for \$52,000, and the loan balance is \$85,000. What does Jeff owe the lender?

Answer 3.

Because the reverse mortgage is nonrecourse, Jeff must repay only the \$52,000 sale price of the house. The remaining \$33,000 has no tax

implications; it is not forgiveness of debt and is not a continuing obligation.

Question 4.

Ella Elliot went through the process to get an HECM reverse mortgage. The closing was yesterday, and she is getting cold feet. She talked to her son after the fact, and he did not think it was a good idea to have a reverse mortgage. Can Ella cancel the mortgage?

Answer 4.

Ella has 3 business days after closing to cancel the mortgage without penalty. Ella has to notify the lender in writing. She should send the letter certified mail, return receipt requested, and keep copies of what was sent. If Ella paid any money for the financing, the lender must return it within 20 days.

Question 5.

Bob and Barbara Bailey have considered their options and believe that a reverse mortgage would be a good solution to their need for supplemental retirement income. They meet all of the qualifications for a reverse mortgage, except that they still owe money on their mortgage. Do Bob and Barbara qualify?

Answer 5.

If the remaining mortgage is relatively low, it can be paid off at closing with part of the proceeds of the reverse loan. If it is not relatively low, they do not qualify.

Question 6.

Carol and Carl Carson are trying to decide between a home equity loan and a reverse mortgage. Their home is valued at \$500,000. Which is the better option?

Answer 6.

There are different answers for different people. A home equity loan has low closing costs and few, if any, fees. It has no age requirements and a lower interest rate, but it takes good to excellent credit to get one, and it requires monthly payments, which could result in losing the home in a foreclosure.

Because a reverse mortgage requires no monthly payments, it avoids the risk of foreclosure. But, it is a complicated process and is also more expensive than a home equity loan. Still, it might be the right answer for Carol and Carl if they have a lot of equity in their home but have limited cash flow. The lending limit from an FHA HECM is the lesser of the \$500,000 appraised value or the \$625,000 HECM FHA mortgage limit. Carol and Carl should also consider the effect of the reverse mortgage when their children inherit the home.

Question 7.

Morris Mayes is trying to understand the consequences of a reverse mortgage. He owns a house that is currently valued at \$75,000. His reverse mortgage debt is \$45,000. If he dies today, what happens to the \$30,000 difference?

Answer 7.

The reverse mortgage lender is entitled to only the debt amount, so the remaining \$30,000 can pass to Morris's heirs. If the house sells for more than \$75,000, the heirs will get more. The payment to the reverse lender comes first. The heirs also have the option to pay off the \$45,000 debt and keep the house.

ISSUE 5: NET UNREALIZED APPRECIATION This issue reviews the tax treatment of net unrealized appreciation in employer securities.

Net unrealized appreciation (NUA) is the net increase in the value of employer securities while they were held in a retirement plan trust. The types of employer securities that are included are stocks, bonds, registered debentures, and debentures with interest coupons attached.

Basic Tax Rules

NUA in employer securities received as a lump sum distribution is taxed as follows:

- The full value of the distribution is ordinary income.

- The cost basis of the security in the hands of the plan owner is the fair market value (FMV) of the security on the date of the distribution.
- Capital gains rules apply when the security is sold.

A lump sum distribution is the payment, in 1 tax year, of the plan participant's entire balance from all of the employer's qualified plans of one kind (pension, profit-sharing, or stock bonus). The distribution must be paid in one or more of the following circumstances:

1. Because of the plan participant's death
2. After the participant reaches age 59½
3. Because the participant, if an employee, separates from service
4. After a self-employed participant becomes totally and permanently disabled

The owner's basis in a lump sum distribution is the total of

- the owner's contributions to the plan that are attributable to the securities,
- the employer's contributions that were taxed as ordinary income in the year the securities were distributed, and
- the owner's NUA in the securities that is attributable to employer contributions and taxed as ordinary income in the year the securities were distributed.

Example 3.16 Tax Treatment of Distribution

Larry Lawson left ABC Corporation in 2015. He received a full distribution of his 401(k) plan. His Form 1099-R shows that he received \$3,000 of NUA and a \$15,000 total distribution. The entire distribution (including the NUA) is taxable as ordinary income. His cost basis is equal to the \$15,000 FMV of the security on the date of the distribution. If Larry sells all of the stock 6 months later for \$18,000, he has a \$3,000 (\$18,000 – \$15,000) short-term capital gain.

Special Tax Treatment

Taxpayers can elect to defer tax on the NUA in a lump sum distribution. If the distribution does not meet the lump sum requirements, the tax is deferred only on NUA resulting from employee contributions that were not deductible voluntary employee contributions.

When the employer securities are eventually sold or exchanged, gain is long-term up to the amount of NUA that is not included in basis. Any gain that is more than the NUA is either long-term or short-term, depending on the length of time the securities were held after the distribution.

Example 3.17 Employer Securities That Include NUA

Lilly Lewis worked for ABC Corporation for 15 years. During that time she was part of its 401(k) plan, which contained both company stock and other securities. She made pretax contributions to her 401(k) totaling \$10,000, and ABC contributed \$3,000. In 2015 Lilly was 62 years old and took a distribution of all of her plan securities. According to her Form 1099-R, NUA in the employer securities was \$5,000, and the full amount of the distribution was \$18,000. She did not sell any of the securities during the first full year after she received them. If Lilly met the qualifications for a lump sum distribution, the NUA is deferred until she sells the stock. Her contributions and the contributions made by the company are taxable as ordinary income in the year of distribution, and Lilly has a \$13,000 (\$18,000 – \$5,000) basis in the distributed stock.

Example 3.18 Gain on the Sale of Employer Securities with NUA

Using the facts in Example 3.17, if Lilly receives \$20,000 from selling all of the securities 2 years after the distribution, the deferred \$5,000 NUA is taxed as long-term capital gain because she held the stock for more than 1 year. The remaining \$7,000 gain (\$20,000 selling price – \$13,000 basis) is also taxed as long-term capital gain. If Lilly did not meet the qualifications for a lump sum distribution, her NUA could still be deferred until she sells the stock, because she has no basis in the NUA.

Transfer Options

When an owner decides to take company stock and/or the cash value out of a 401(k), the owner may consider a transfer of the stock to an IRA, or a transfer of the stock to a taxable brokerage account.

Transfer to an IRA

Many financial advisers recommend transferring a corporate retirement plan to an IRA when leaving the company. A departing employee can transfer company stock to an IRA, but the employee should consider the following factors:

- A transfer to an IRA changes the tax rates from capital gains to ordinary income. If there is a substantial amount of NUA, that could have a negative tax effect.
- If the owner intends to hold the stock for a long period before selling it, it will be advantageous to keep the stock in an IRA tax-deferred account.
- If the owner is not yet age 59½, a transfer to an IRA will avoid the early withdrawal penalty.

Transfer to a Taxable Brokerage Account

If the employer stock is transferred to a brokerage firm, the option to defer tax on the NUA is still available. Not all of the distribution has to go to the taxable account; if it includes securities other than company stock, those securities could be transferred to an IRA, and the company stock could be transferred to the brokerage firm. The cost basis is taxable in the current year, but the tax on the NUA is deferred until the stock is sold. Other considerations include the following:

- Only a full distribution qualifies for the NUA special treatment. The owner is allowed to make several distributions in a year, but the entire account must be closed out by the end of the year. If the NUA election is not allowed, all distributions are subject to ordinary income tax and penalties.
- Amounts distributed as cash instead of actual shares will not qualify for special NUA

treatment. Cash distributions are immediately taxable as ordinary income.

- A taxpayer in a high tax bracket usually receives a greater tax benefit from electing special NUA treatment instead of transferring all of the funds to an IRA.



Practitioner Note

Disallowed Full Distribution

If the owner fails to make a full distribution, and the NUA election is not allowed, noncompany stock transferred to an IRA is not subject to the tax imposed due to the failure to make a full distribution.

Example 3.19 Making the NUA Election

Connor Calhoun, age 52, wanted to retire early. His 401(k) included \$200,000 in company stock that he purchased for \$45,000 pretax, and his NUA was \$155,000 (\$200,000 – \$45,000). He is in the 35% tax bracket. In 2015 Connor transferred his 401(k) assets (which were solely employer stock) to an IRA and then took a full distribution from the IRA. The entire \$200,000 is taxable as ordinary income, so his tax is \$70,000 (\$200,000 × 35%). There is also a \$20,000 (\$200,000 × 10%) early withdrawal penalty. His total tax on the distribution is \$90,000 (\$70,000 + \$20,000), and Connor would have \$110,000 (\$200,000 – \$90,000) left to fund other investments.

If instead Connor made the NUA election, and transferred the entire amount into a taxable brokerage account, the only portion that is immediately taxable is the cost basis, so the tax and early withdrawal penalty apply to only \$45,000. His tax amount on the distribution is \$20,250 (the tax on \$45,000 at 35% is \$15,750, and the 10% penalty is \$4,500). When the stock is cashed in immediately after the transfer, the long-term capital gain rate applies. Because Connor has a \$45,000 basis, only \$155,000 (\$200,000 – \$45,000) is taxable. His tax on the capital gain is \$23,250 (\$155,000 × 15%), and his total tax is \$43,500 (\$20,250 + \$23,250). His available cash after tax is \$156,500 (\$200,000 – \$43,500).

Question 1.

What if Connor does not cash in the stock until early the next year?

Answer 1.

He will lose the long-term capital gain rates and have to pay tax at his 35% ordinary income rate. His total tax will be \$74,500 [\$20,250 initial tax + \$54,250 ($\$155,000 \times 35\%$) ordinary income tax].

Question 2.

What if Connor transfers the entire amount to an IRA and does not cash in the stock for 10 years?

Answer 2.

The rollover to the IRA avoids the early withdrawal penalty. Connor does not have to pay taxes on dividends received during the 10-year period. If the stock appreciates substantially, the tax-deferred growth may be more advantageous than making the NUA election.

Other Considerations

Tax benefits are not the only reason to make an investment decision. The tax may be less, but the taxpayer may have to sell part of the company stock to pay the tax. Also, additional income could make more social security taxable, decrease the allowable itemized deductions, or reduce the allowable exemptions. Diversification in security holdings is also an important consideration.

Form 4972

Form 4972, Tax on Lump-Sum Distributions, can be used to report the Form 1099-R information as well as to make a 20% capital gain election and elect to calculate the tax using the 10-year tax option. The form can be used for one election or for both. To make the Form 4972 elections, the plan participant must meet the qualifications for a lump sum distribution discussed previously, and the following requirements must be met:

1. No part of the distribution can be rolled over.
2. The plan participant must have been born before January 2, 1936, and have been a participant in the plan for at least 5 years before the year of the distribution.
3. If the distribution was made to a beneficiary, the deceased plan participant must have been born before January 2, 1936.
4. After 1986, Form 4972 can be used only one time for each plan participant.

20% Capital Gain Election

The 20% capital gain election applies to the part of the distribution made before 1974, and it is reported in box 3 on Form 1099-R.

The IRS NUA worksheet is shown as Figure 3.9. The worksheet calculates the portion of the NUA that is added to the capital gain election amount.

Example 3.20 NUA Worksheet

Bonnie Bailey received the Form 1099-R shown in **Figure 3.8** after taking a lump sum distribution from her 401(k). Bonnie meets all of the qualifications for using Form 4972. She wants to elect the 20% capital gain treatment.

The \$16,250 capital gain portion of Bonnie's distribution is calculated on the NUA worksheet, shown in **Figure 3.9**. Bonnie reports the \$16,250 NUA on line 6 of Form 4972, Part II, and she reports \$3,250 ($\$16,250 \times 20\%$) on line 7. See Figure 3.10.

10-Year Tax Option

The 10-year tax option is a special formula used to figure a separate tax on the ordinary income part of a lump sum distribution. It is not paid over a 10-year period, but only in the year of the distribution. The ordinary income is the amount in box 2a of Form 1099-R minus any amount shown in box 3, but it must be adjusted for the NUA by adding in the line F amount from the worksheet. If the capital gain shown in box 3 is not used for the 20% capital gain treatment, it is included as ordinary income for the 10-year tax option.

FIGURE 3.8 Bonnie Bailey's Form 1099-R

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, and ZIP or foreign postal code ACME Financial, Inc. 1000 Golden Avenue Big City, USA 00001		1 Gross distribution \$ 260000.00 2a Taxable amount \$ 160000.00 2b Taxable amount not determined <input type="checkbox"/>	OMB No. 1545-0119 <div style="font-size: 2em; font-weight: bold;">2015</div> Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Copy B Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return. This information is being furnished to the Internal Revenue Service.
PAYER'S federal identification number 39-4972001	RECIPIENT'S identification number 010-99-4972	3 Capital gain (included in box 2a) \$ 10000.00	4 Federal income tax withheld \$ 50000.00	
RECIPIENT'S name Bonnie Bailey Street address (including apt. no.) 429 Lorch Street City or town, state or province, country, and ZIP or foreign postal code Anywhere, USA 00002		5 Employee contributions /Designated Roth contributions or insurance premiums \$	6 Net unrealized appreciation in employer's securities \$ 100000.00	
		7 Distribution code(s) IRA/SEP/SIMPLE <input type="checkbox"/>	8 Other \$ 20000.00 %	
		9a Your percentage of total distribution %	9b Total employee contributions \$	
10 Amount allocable to IRR within 5 years \$	11 1st year of desig. Roth contrib.	12 State tax withheld \$	13 State/Payer's state no.	14 State distribution \$
Account number (see instructions)		15 Local tax withheld \$	16 Name of locality	17 Local distribution \$
		15 Local tax withheld \$	16 Name of locality	17 Local distribution \$
		15 Local tax withheld \$	16 Name of locality	17 Local distribution \$

Form **1099-R**
www.irs.gov/form1099r
Department of the Treasury - Internal Revenue Service

FIGURE 3.9 NUA Worksheet from Form 4972 Instructions

NUA Worksheet (keep for your records)		
A. Enter the amount from Form 1099-R, box 3	A. <u>10,000</u>	
B. Enter the amount from Form 1099-R, box 2a	B. <u>160,000</u>	
C. Divide line A by line B and enter the result as a decimal (rounded to at least three places)	C. <u>.0625</u>	
D. Enter the amount from Form 1099-R, box 6	D. <u>100,000</u>	
E. Capital gain portion of NUA. Multiply line C by line D	E. <u>6,250</u>	
F. Ordinary income portion of NUA. Subtract line E from line D	F. <u>93,750</u>	
G. Total capital gain portion of distribution. Add lines A and E. Enter here and on Form 4972, line 6. On the dotted line next to line 6, write "NUA" and the amount from line E above	G. <u>16,250</u>	

Example 3.21 10-Year Option

Using the facts in Example 3.20, Bonnie Bailey's \$55,870 tax on her \$250,000 lump sum distribution is shown on line 30 of the Form 4972 in

Figure 3.10. The \$243,750 reported on line 8 is \$160,000 from box 2a of Form 1099-R, minus \$10,000 from box 3 of Form 1099-R, plus \$93,750 from line F of the NUA Worksheet.

FIGURE 3.10 Bonnie Bailey's Form 4972

Form 4972 Department of the Treasury Internal Revenue Service (99)	Tax on Lump-Sum Distributions (From Qualified Plans of Participants Born Before January 2, 1936) ► Information about Form 4972 and its instructions is available at www.irs.gov/form4972 . ► Attach to Form 1040, Form 1040NR, or Form 1041.	OMB No. 1545-0193 2015 Attachment Sequence No. 28						
Name of recipient of distribution Bonnie Bailey		Identifying number 010-99-4972						
Part I Complete this part to see if you can use Form 4972								
1 Was this a distribution of a plan participant's entire balance (excluding deductible voluntary employee contributions and certain forfeited amounts) from all of an employer's qualified plans of one kind (for example, pension, profit-sharing, or stock bonus)? If "No," do not use this form		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:25%;">Yes</th> <th style="width:25%;">No</th> </tr> <tr> <td>1</td> <td style="text-align: center;">✓</td> <td></td> </tr> </table>		Yes	No	1	✓	
	Yes	No						
1	✓							
2 Did you roll over any part of the distribution? If "Yes," do not use this form		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:25%;">Yes</th> <th style="width:25%;">No</th> </tr> <tr> <td>2</td> <td></td> <td style="text-align: center;">✓</td> </tr> </table>		Yes	No	2		✓
	Yes	No						
2		✓						
3 Was this distribution paid to you as a beneficiary of a plan participant who was born before January 2, 1936?		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:25%;">Yes</th> <th style="width:25%;">No</th> </tr> <tr> <td>3</td> <td></td> <td style="text-align: center;">✓</td> </tr> </table>		Yes	No	3		✓
	Yes	No						
3		✓						
4 Were you (a) a plan participant who received this distribution, (b) born before January 2, 1936, and (c) a participant in the plan for at least 5 years before the year of the distribution? If you answered "No" to both questions 3 and 4, do not use this form.		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:25%;">Yes</th> <th style="width:25%;">No</th> </tr> <tr> <td>4</td> <td style="text-align: center;">✓</td> <td></td> </tr> </table>		Yes	No	4	✓	
	Yes	No						
4	✓							
5a Did you use Form 4972 after 1986 for a previous distribution from your own plan? If "Yes," do not use this form for a 2015 distribution from your own plan		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:25%;">Yes</th> <th style="width:25%;">No</th> </tr> <tr> <td>5a</td> <td></td> <td style="text-align: center;">✓</td> </tr> </table>		Yes	No	5a		✓
	Yes	No						
5a		✓						
b If you are receiving this distribution as a beneficiary of a plan participant who died, did you use Form 4972 for a previous distribution received as a beneficiary of that participant after 1986? If "Yes," do not use this form for this distribution		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:25%;">Yes</th> <th style="width:25%;">No</th> </tr> <tr> <td>5b</td> <td></td> <td style="text-align: center;">✓</td> </tr> </table>		Yes	No	5b		✓
	Yes	No						
5b		✓						
Part II Complete this part to choose the 20% capital gain election (see instructions)								
6 Capital gain part from Form 1099-R, box 3		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>6</td> <td style="text-align: right;">16,250</td> </tr> </table>		Amount	6	16,250		
	Amount							
6	16,250							
7 Multiply line 6 by 20% (.20)		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>7</td> <td style="text-align: right;">3,250</td> </tr> </table>		Amount	7	3,250		
	Amount							
7	3,250							
If you also choose to use Part III, go to line 8. Otherwise, include the amount from line 7 in the total on Form 1040, line 44; Form 1040NR, line 42; or Form 1041, Schedule G, line 1b.								
Part III Complete this part to choose the 10-year tax option (see instructions)								
8 If you completed Part II, enter the amount from Form 1099-R, box 2a minus box 3. If you did not complete Part II, enter the amount from box 2a. Multiple recipients (and recipients who elect to include NUA in taxable income) see instructions		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>8</td> <td style="text-align: right;">243,750</td> </tr> </table>		Amount	8	243,750		
	Amount							
8	243,750							
9 Death benefit exclusion for a beneficiary of a plan participant who died before August 21, 1996		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>9</td> <td style="text-align: right;">0</td> </tr> </table>		Amount	9	0		
	Amount							
9	0							
10 Total taxable amount. Subtract line 9 from line 8		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>10</td> <td style="text-align: right;">243,750</td> </tr> </table>		Amount	10	243,750		
	Amount							
10	243,750							
11 Current actuarial value of annuity from Form 1099-R, box 8. If none, enter -0-		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>11</td> <td style="text-align: right;">20,000</td> </tr> </table>		Amount	11	20,000		
	Amount							
11	20,000							
12 Adjusted total taxable amount. Add lines 10 and 11. If this amount is \$70,000 or more, skip lines 13 through 16, enter this amount on line 17, and go to line 18		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>12</td> <td style="text-align: right;">263,750</td> </tr> </table>		Amount	12	263,750		
	Amount							
12	263,750							
13 Multiply line 12 by 50% (.50), but do not enter more than \$10,000		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>13</td> <td></td> </tr> </table>		Amount	13			
	Amount							
13								
14 Subtract \$20,000 from line 12. If line 12 is \$20,000 or less, enter -0-		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>14</td> <td></td> </tr> </table>		Amount	14			
	Amount							
14								
15 Multiply line 14 by 20% (.20)		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>15</td> <td></td> </tr> </table>		Amount	15			
	Amount							
15								
16 Minimum distribution allowance. Subtract line 15 from line 13		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>16</td> <td></td> </tr> </table>		Amount	16			
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17 Subtract line 16 from line 12		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>17</td> <td style="text-align: right;">263,750</td> </tr> </table>		Amount	17	263,750		
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17	263,750							
18 Federal estate tax attributable to lump-sum distribution		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>18</td> <td style="text-align: right;">0</td> </tr> </table>		Amount	18	0		
	Amount							
18	0							
19 Subtract line 18 from line 17. If line 11 is zero, skip lines 20 through 22 and go to line 23		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>19</td> <td style="text-align: right;">263,750</td> </tr> </table>		Amount	19	263,750		
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19	263,750							
20 Divide line 11 by line 12 and enter the result as a decimal (rounded to at least three places)		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>20</td> <td style="text-align: right;">.0758</td> </tr> </table>		Amount	20	.0758		
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20	.0758							
21 Multiply line 16 by the decimal on line 20		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>21</td> <td style="text-align: right;">0</td> </tr> </table>		Amount	21	0		
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22 Subtract line 21 from line 11		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>22</td> <td style="text-align: right;">20,000</td> </tr> </table>		Amount	22	20,000		
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22	20,000							
23 Multiply line 19 by 10% (.10)		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>23</td> <td style="text-align: right;">26,375</td> </tr> </table>		Amount	23	26,375		
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23	26,375							
24 Tax on amount on line 23. Use the Tax Rate Schedule in the instructions		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>24</td> <td style="text-align: right;">5,490</td> </tr> </table>		Amount	24	5,490		
	Amount							
24	5,490							
25 Multiply line 24 by ten (10). If line 11 is zero, skip lines 26 through 28, enter this amount on line 29, and go to line 30		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>25</td> <td style="text-align: right;">54,900</td> </tr> </table>		Amount	25	54,900		
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26 Multiply line 22 by 10% (.10)		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>26</td> <td style="text-align: right;">2,000</td> </tr> </table>		Amount	26	2,000		
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27 Tax on amount on line 26. Use the Tax Rate Schedule in the instructions		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>27</td> <td style="text-align: right;">228</td> </tr> </table>		Amount	27	228		
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27	228							
28 Multiply line 27 by ten (10)		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>28</td> <td style="text-align: right;">2,280</td> </tr> </table>		Amount	28	2,280		
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28	2,280							
29 Subtract line 28 from line 25. Multiple recipients see instructions		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>29</td> <td style="text-align: right;">52,620</td> </tr> </table>		Amount	29	52,620		
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29	52,620							
30 Tax on lump-sum distribution. Add lines 7 and 29. Also include this amount in the total on Form 1040, line 44; Form 1040NR, line 42; or Form 1041, Schedule G, line 1b		<table border="1" style="width:100%;"> <tr> <th style="width:50%;"></th> <th style="width:50%;">Amount</th> </tr> <tr> <td>30</td> <td style="text-align: right;">55,870</td> </tr> </table>		Amount	30	55,870		
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30	55,870							

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 13187U

Form **4972** (2015)

If Bonnie had not elected to use the 20% capital gain treatment, the entire \$250,000 distribution would be eligible for 10-year averaging. The taxable portion of the annuity would not change, but the tax on the ordinary income would be \$54,490.



Observation Age Requirement for Form 4972

Plan participants who meet the born before January 2, 1936, requirement will be at least 79 years old on January 1, 2016. However, the 10-year averaging can also be used by beneficiaries of eligible participants. If the beneficiary elects to take a lump sum distribution, the 10-year averaging is available to the beneficiary of someone who met the age requirements.

ISSUE 6: SALE OF A BUSINESS This issue discusses employee protection as well as tax considerations when a retiring owner sells his or her business.

Individuals who are preparing for retirement face a changing lifestyle and have to make significant decisions that will affect them for the rest of their lives. This is compounded for the business owner who has to plan for the transfer of his or her business. Ownership may transfer to any of the following:

- Family members or a family trust: The transfer may be a gift, part gift and part sale, or an installment sale.
- Key employees: The transfer is typically a sale or installment sale, possibly at a discount.
- Outside buyer: The transfer is usually a sale or an installment sale for fair market value (FMV).

Considerations for Protecting Employees

Many small business owners want to protect their employees following a sale of the business.

Business owners could consider establishing and selling the business to an employee stock ownership plan (ESOP). Typically, for a business owner to receive full value for the business, an ESOP is established and funded with employer retirement contributions [replacing profit-sharing and/or 401(k) contributions]. This allows the ESOP to build up cash assets. The ESOP then

borrows money from a bank, using the loan proceeds and retirement plan assets to purchase the interests of the owner. Note that ESOPs are not available for entities taxed as partnerships.

Another way to protect employees is to attempt to select a buyer for the business who will continue the employment of either key or all employees. Unfortunately, this may preclude a sale to an out-of-area buyer who will relocate the business, or to a local competitor who may consolidate facilities and use its own employees more efficiently. The business owner needs to determine if attempting to keep the employees in their positions will result in a lower overall sale price, and if the owner is willing to forgo potential sale proceeds to protect those employees. Of course, even when everything possible is done to protect the employees' employment, once the business is sold the former owner has very little control, and the new owner could still relocate or downsize.

Some employers have certain key employees that they would like to compensate, as opposed to trying to protect all employees. In this case employee contracts, deferred compensation plans, or one-time bonuses can be used to compensate those key employees.

The tax consultant needs to determine to what extent, if any, the business owner wants to protect current employees, and should discuss ways to protect those employees and the overall cost to the seller.

Tax Considerations for Business Sales

Sales of businesses are complex tax transactions, and tax consequences vary greatly depending on the business structure. This issue focuses on sales of businesses operated as C corporations and S corporations, and on sales of entities taxed as partnerships.

Example 3.22 Balance Sheet

Windsor Doe and Ryan Doe, who are brothers, own Doe Family Enterprises. Windsor owns 60%, and Ryan owns 40%. The brothers are selling the business and retiring. The business was originally started with contributions of \$60 from Windsor and \$40 from Ryan. No ownership changes were made prior to the sale. The entity has \$150 (\$250 equity – \$100 initial investment) retained income.

Figure 3.11 shows their balance sheet, used throughout this issue to review the tax implications for different types of entities.

**FIGURE 3.11 Doe Family Enterprises
Balance Sheet**

Description	Tax Basis	FMV
Cash	\$ 50	\$ 50
Accounts receivable	200	200
Inventory	200	400
Equipment	400	300
Accumulated depreciation	(300)	---
Total assets	\$ 550	\$ 950
Accounts payable	\$ 150	\$ 150
Loan payable to bank	150	150
Equity	250	650
Total liabilities and equity	\$ 550	\$ 950

In the following discussion of the tax impacts for each type of entity, consider the following options to sell 100% of the business:

1. Sale of the ownership units (stock, partnership interest, or LLC units)
2. Sale of the assets of the business, followed by a distribution of cash, any installment note

receivable from the sale of the assets, and any assets retained by the company after the sale, such as officer vehicles and nonbusiness assets such as securities portfolios

3. Liquidation of the entity by distributing all assets pro rata to the owners, followed by a sale of the assets to a third party

C Corporation

With a corporate entity, it is unusual to have a liquidation of assets followed by a sale. Therefore, the sale is typically structured as a stock sale or an asset sale. Most sellers prefer a stock sale for tax and nontax reasons. Usually there is only one level of taxable income, which is taxed as a capital gain. The nontax advantage is that the seller has no continuing obligation for most liabilities (known and unknown) of the corporation.

The buyer typically prefers an asset sale. The stock purchase leaves the buyer with a carryover basis in the assets and a high basis in the stock, which does not benefit the buyer until it disposes of its interest or liquidates the corporation. An asset sale gives the buyer a higher basis in the underlying assets and an ability to depreciate the purchase price to offset income. From a legal standpoint buyers do not want responsibility for liabilities that may have been incurred prior to their ownership, and an asset sale avoids the responsibility for potentially unknown liabilities.

Pursuant to I.R.C. § 338, a purchaser of corporate stock can elect to treat the transaction as an asset sale. This election can provide administrative ease, as titles to property do not have to be changed, leases do not have to be revised, payroll and other tax accounts can continue uninterrupted, and franchise and other agreements do not have to be assigned. For tax purposes the entire transaction is treated as a sale of assets, but for legal purposes it is treated as a stock sale. Thus, the purchaser assumes all liabilities of the entity, including any liabilities that are unknown due to prior acts.

Sale of Stock

A sale of the entire stock of a corporation will result in capital gain or loss to the seller, and possibly net investment income tax (NIIT). Unless the corporation is part of an affiliated group, there is no tax impact on the corporation. The purchaser will have a basis in the stock equal to

the purchase price but will receive no immediate deductions based on the purchase price.

Example 3.23 Sale of C Corporation Stock

Doe Family Enterprises from Example 3.22 is a C corporation. Windsor owns 60 shares, and Ryan owns 40 shares. Windsor and Ryan enter into an agreement to sell all their shares to Dillon Jones for \$650 (the FMV of the equity). **Figure 3.12** shows the shareholders' gain from the sale of C corporation stock sale.

**FIGURE 3.12 Gain
from Sale of C Corporation Stock**

	Windsor	Ryan	Total
Proceeds from sale of stock	\$ 390	\$ 260	\$ 650
Basis in stock	(60)	(40)	(100)
Taxable gain	<u>\$ 330</u>	<u>\$ 220</u>	<u>\$ 550</u>

There is no gain inside the corporation. Windsor and Ryan pay tax at long-term capital gain rates on the total \$550 gain. Assuming a 20% rate, they will have a \$110 personal tax liability, and after-tax proceeds of \$540 (\$650 – \$110). Windsor and Ryan may also have to pay NIIT. Dillon has a \$650 basis in the corporate stock, and there is no change in the basis of the corporation's assets.

Asset Sale

In an asset sale there are two distinct levels of tax:

1. The corporation sells its assets, resulting in gain or loss taxed at the corporate level.
2. The corporation then liquidates and distributes cash to the shareholders. The shareholders recognize gain based on the difference between the liquidation proceeds and their basis in the corporate stock. This second tier of gain is usually long-term capital gain.

The assets that were in the corporation have a new basis equal to their purchase price, and the purchaser can expense, depreciate, or include them in cost of goods sold.

Example 3.24 Sale of C Corporation Assets

Doe Family Enterprises from Example 3.22 is a C corporation. Windsor and Ryan enter into an agreement to sell the assets of the corporation to Dillon Jones for \$900 (the FMV of assets excluding cash). The corporation uses the \$900 and the \$50 remaining cash to pay down the \$300 liabilities, leaving \$650 net pretax proceeds (which equals the sale price in Example 3.23). **Figure 3.13** shows the tax consequences of a sale of C corporation assets.

Assuming a 25% tax on the corporate gain, the corporation pays \$100 ($\$400 \times 25\%$) in tax.

Windsor and Ryan pay tax at long-term capital gain rates on the total \$450 of gain. Assuming a 20% rate, they have a \$90 ($\$450 \times 20\%$) personal tax liability, and possibly NIIT. After-tax proceeds to the owners are \$460 ($\$550 - \90 taxes due), which is \$80 ($\$540 - \460) less than the after-tax proceeds from the stock sale.

Dillon will form a new business entity to hold the assets purchased, and those assets have a basis equal to the purchase price (FMV).

When a purchaser demands an asset sale, the seller can negotiate with the purchaser to allocate a portion of the purchase price to personal goodwill. By allocating the goodwill from the corporation to the individual shareholders, the gain from the sale of assets can be divided between the corporation and the shareholders. By dividing the gain between assets owned by the corporation and assets owned by the shareholders, one level of tax can be avoided on the sale of the assets owned by the shareholders. This reduces the amount of gain at the corporate level, thereby reducing the total tax liability upon liquidation of the corporation.

Valuation of personal goodwill is important. Careful review of the facts and circumstances of the business is required to determine if personal goodwill can be used as a portion of the overall sale.

Example 3.25 Allocation of Purchase Price to Goodwill

Windsor and Ryan from Example 3.24 negotiate an allocation of \$50 of the purchase price to their personal goodwill. **Figure 3.14** shows the \$350 corporate gain and \$462 owner gain.

FIGURE 3.13 Sale of C Corporation Assets

Corporate-Level Gain	Basis	Sales Proceeds	Corporate-Level Gain
Accounts receivable	\$ 200	\$ 200	\$ 0
Inventory	200	400	200
Equipment	100	300	200
Total	<u>\$ 500</u>	<u>\$ 900</u>	<u>\$ 400</u>

Owner-Level Gain	Owner-Level Gain
Beginning cash	\$ 50
Corporate sales proceeds	900
Corporate taxes paid (\$400 × 25%)	(100)
Liabilities paid	(300)
Net cash to distribute in liquidation	<u>\$ 550</u>

Tax to Owners	Windsor	Ryan	Total
Proceeds from sale of stock	\$ 330	\$ 220	\$ 550
Basis in stock	(60)	(40)	(100)
Taxable gain	<u>\$ 270</u>	<u>\$ 180</u>	<u>\$ 450</u>

FIGURE 3.14 Sale of Assets with Personal Goodwill

Corporate-Level Gain	Basis	Sales Proceeds	Corporate-Level Gain
Accounts receivable	\$ 200	\$ 200	\$ 0
Inventory	200	400	200
Equipment	100	250	150
Total	<u>\$ 500</u>	<u>\$ 850</u>	<u>\$ 350</u>

Owner-Level Gain	Owner-Level Gain
Beginning cash	\$ 50
Corporate sales proceeds	850
Corporate taxes paid (\$350 × 25%)	(88)
Liabilities paid	(300)
Net cash to distribute in liquation	<u>\$ 512</u>

Tax to Owners	Windsor	Ryan	Total
Proceeds from sale of stock	\$ 307	\$ 205	\$ 512
Proceeds from sale of goodwill	30	20	50
Basis in stock	(60)	(40)	(100)
Taxable gain	<u>\$ 277</u>	<u>\$ 185</u>	<u>\$ 462</u>

Assuming a 25% tax on the corporate gain, the corporation pays \$88 ($\$350 \times 25\%$) in tax.

Windsor and Ryan pay tax at long-term capital gain rates on the total \$462 of gain. Assuming a 20% rate, they have a \$92 ($\$462 \times 20\%$) personal tax liability, and possibly NIIT. After-tax proceeds to the owners are \$470 (\$512 cash + \$50 goodwill – \$92 taxes due), a savings of \$10 ($\$470 - \460) as a result of allocating proceeds to personal goodwill.

Dillon will form a new business entity to hold the assets purchased, which have a basis equal to the purchase price (FMV).

Liquidation and Sale of C Corporation Assets

When a corporation makes a liquidating distribution of property, the distributed property is treated as though it was sold for FMV, and the value must be at least equal to any debt associated with the property (the deemed sale price). This results in a tax at both the corporate and individual levels that will be either equal to or higher than the tax that would be incurred on a sale of the assets by the corporation.

A subsequent sale of the property by the shareholders could also accelerate income. The tax is higher if debt attached to the property exceeds the actual sale price. The corporation recognizes more income because the deemed sale price is higher than the actual sale price, which is offset by a capital loss on the individual level. Tax is accelerated if the ultimate sale is an installment sale, as the deemed sale rule requires recognition of the full amount of corporate gain at the time of the property distribution. The shareholders receive a higher outside basis, which reduces or eliminates the gain on the installment sale.

I.R.C. § 453 allows distributions of installment obligations by corporations to be treated as a distribution in the form of an installment obligation, and the tax-deferral nature of the original obligation is preserved. This exception to recognizing gain applies if the installment obligation is a “qualified installment obligation,” meaning that it was generated on the sale of the business assets and distributed to the shareholders within 12 months of the sale, in exchange for shareholder stock and under a plan of liquidation.

S Corporation

If an S corporation was previously a C corporation, the built-in gains tax rules may apply. An S corporation is subject to the corporate-level built-in gains tax for the first 10 years (the 10-year limit has been shortened at different times for economic reasons) following election of S status. For purposes of this issue, it is assumed that subchapter S status was elected at inception.

Similar to a C corporation, it is unusual to have a liquidation of assets followed by a sale. S corporation sales are usually either a stock sale or an asset sale. The same tax and nontax reasons that pertain to C corporations also apply to S corporations. The provisions of I.R.C. § 338 are also available to S corporations.

Sale of Stock

An S corporation shareholder will have capital gain or loss on the sale of the S corporation stock, and possibly NIIT. If the new shareholders include an ineligible shareholder, the S election will be terminated. The new owners could also choose to revoke the S election.

The buyers have a basis in the stock equal to the purchase price, which may allow for additional nontaxable distributions or larger allowable tax deductions to pass through to the owners. The buyers receive no immediate deduction or depreciation deductions based on the purchase price.



Observation Stock Basis Increased by Earnings

Note that with an S corporation the basis in stock is increased by the earnings retained by the corporation, which reduces the overall gain when compared to a sale of C corporation stock.

Example 3.26 Sale of S Corporation Stock

Doe Family Enterprises from Example 3.22 is an S corporation. Windsor owns 60 shares, and Ryan owns 40 shares. Windsor and Ryan enter into an agreement to sell all their shares to Dillon Jones for \$650 (the FMV of the equity). **Figure 3.15** shows the gain from the sale of the S corporation stock.

FIGURE 3.15 Sale of S Corporation Stock

	Windsor	Ryan	Total
Proceeds from sale of stock	\$ 390	\$ 260	\$ 650
Basis in stock	(150)	(100)	(250)
Taxable gain	<u>\$ 240</u>	<u>\$ 160</u>	<u>\$ 400</u>

There is no gain inside the corporation. There is no change in the basis of the corporation's assets.

Windsor and Ryan pay tax at long-term capital gain rates on the total \$400 gain and may pay NIIT. Assuming a 20% rate, they have a personal tax liability of \$80 ($\$400 \times 20\%$). After-tax proceeds to the owners are \$570 ($\$650 - \80 taxes due). It is important to note that the shareholders paid tax on the \$150 of retained corporate income in prior years, resulting in a basis increase.

Dillon has a \$650 basis in the corporate stock, and the basis of the corporate assets does not change.

Asset Sale

In a sale of assets of an S corporation that is not subject to built-in gains tax, or any other corporate-level taxes, there are two distinct levels of income recognition but only one level of tax:

1. The corporation sells all its assets, resulting in taxable gain or loss that is passed through to the shareholders; and
2. The corporation liquidates and distributes cash to the shareholders. The shareholder's gain is the difference between the liquidation proceeds and the shareholder's basis in the corporate stock. This second tier of gain is usually long-term capital gain.

The assets that were in the corporation have a new basis equal to their purchase price, which the buyer can depreciate, expense, or include in cost of goods sold.

Example 3.27 Sale of S Corporation Assets

Doe Family Enterprises from Example 3.22 is an S corporation. Windsor and Ryan enter into an agreement to sell the assets of their S corporation to Dillon Jones for \$900 (the FMV of the assets excluding cash). The corporation will use the \$900 plus the \$50 cash to pay down the \$300

liabilities, leaving \$650 net before-tax proceeds to the corporation (which equals the sale price in Example 3.26). **Figure 3.16** shows the corporate- and owner-level gains from the sale of the S corporation assets.

There is no corporate-level tax on the gain, and the income flows through to the shareholders. If the underlying assets are capital gain property, then the gain passes through as capital gain. Here we assume that the sale of the equipment and inventory is taxed at the 25% ordinary income tax rate (and that the NIIT does not apply), resulting in the following tax to the shareholders: Windsor and Ryan pay ordinary income tax on the \$400 of passed-through gain. Assuming a 25% rate, they have a \$100 ($\$400 \times 25\%$) personal tax liability. After-tax proceeds to the owners are \$550 ($\$650 - \100 taxes due), which is \$20 ($\$570 - \550) less than in a stock sale.

Dillon will form a new business entity to hold the purchased assets, which have a basis equal to the purchase price (FMV).

The same personal goodwill sale opportunity illustrated earlier is available to an S corporation.

Liquidation and Sale of S Corporation Assets

S corporations have the same rules that treat liquidating property distributions as a deemed sale for FMV, and the value has to be at least equal to any debt associated with the property. I.R.C. § 453, which allows a distribution of an installment obligation, is also available to an S corporation.

Entity Taxed as a Partnership

Generally, there are four methods to terminate a partnership interest:

1. Retirement of a partner pursuant to I.R.C. § 736

FIGURE 3.16 Gain on Sale of S Corporation Assets

Corporate-Level Gain	Basis	Sales Proceeds	Corporate-Level Gain
Accounts receivable	\$ 200	\$ 200	\$ 0
Inventory	200	400	200
Equipment	100	300	200
Total	<u>\$ 500</u>	<u>\$ 900</u>	<u>\$ 400</u>
Owner-Level Gain			
Beginning cash	\$ 50		\$ 50
Sales proceeds	900		900
Liabilities paid	(300)		(300)
Net cash to distribute in liquidation	<u>\$ 650</u>		<u>\$ 650</u>
Tax to Owners			
	Windsor	Ryan	Total
Proceeds from sale of stock	\$ 390	\$ 260	\$ 650
Basis in stock (increased by gain pass-through and retained earnings)	(390)	(260)	(650)
Taxable gain	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>
Gain pass-through	<u>\$ 240</u>	<u>\$ 160</u>	<u>\$ 400</u>

2. Pro rata distribution of partnership assets, followed by liquidation of the partnership and then an individual sale of the assets
3. Outright sale of partnership interests, possibly on the installment method
4. Sale of the assets of the partnership

I.R.C. § 736 is used only when some partners are continuing the partnership. If one partner is retiring from a multiowner partnership, the partnership can make liquidating payments to the retiring partner pursuant to I.R.C. § 736.

Pursuant to I.R.C. §§ 751, 741, and 731, a distribution and sale of assets, a partnership interest sale, and a partnership asset sale are all effectively treated as a sale of the underlying assets of the partnership. The purpose of I.R.C. §§ 751, 741, and 731 is to prevent partners from converting ordinary income into capital gain by disposing of their partnership interests instead of their interest in the underlying partnership assets. Pursuant to I.R.C. § 741, the sale of a partnership interest is a capital transaction, except that sales of unrealized receivables and inventory (hot assets) are subject

to I.R.C. § 751. Under I.R.C. § 731 no gain is recognized on a distribution of assets, unless money is distributed in excess of basis. However, I.R.C. § 731(d) provides an exception for the disproportionate distribution of I.R.C. § 751 unrealized receivables and substantially appreciated inventory. An important distinction in I.R.C. § 751 is the interplay of I.R.C. § 751(a) and I.R.C. § 751(b). I.R.C. § 751(a) applies to sales or exchanges of interests, and defines hot assets as unrealized receivables and inventory items. I.R.C. § 751(b) relates to distributions of assets and defines hot items as unrealized receivables and substantially appreciated (120%) inventory items.

While the net tax treatment is the same for a distribution and sale of assets, a partnership interest sale, and a partnership asset sale, there may be timing differences and self-employment (SE) tax differences.

Pro Rata Distribution and Sale

The consequences of a pro rata distribution followed by a sale of the assets are as follows:

1. There is likely no tax on liquidation. The partners generally receive partnership property at the lower of their outside basis or the partnership's inside basis.
2. There is no I.R.C. § 751 transaction because it is a pro rata distribution.
3. If the person is selling assets that may generate earned income subject to SE tax, and the person is not in a trade or business, then SE tax may be avoided.
4. The seller recognizes either ordinary income or capital gain based on the character of the assets sold.
5. On an installment sale the seller immediately recognizes all I.R.C. § 1245 recapture, even though the seller receives no corresponding cash.
6. On the liquidation of the partnership or the sale of assets, to the extent debt is transferred, there is an immediate basis reduction and increased income.
7. On death any installment income still due is income in respect of a decedent (IRD) and does not receive a step-up in basis.
8. The purchaser of the underlying assets receives a basis equal to the purchase price and may be able to take an I.R.C. § 179 deduction (subject to related party rules).
9. The purchaser can operate as a sole proprietorship or can contribute the assets to a new entity.

Installment Sale of Assets or Partnership Interest

Tax treatment of an installment sale of assets or a partnership interest is very similar to a pro rata distribution and installment sale, except that SE tax is recognized on any SE income sold. Additionally, to the extent I.R.C. § 751 applies, the sale of hot assets is taxed as ordinary income. To get a basis step-up for assets inside the partnership, the partnership has to make an I.R.C. § 754 election.

Example 3.28 Sale of Partnership Assets

Doe Family Enterprises from Example 3.22 is a partnership. Windsor and Ryan enter into an agreement to sell the assets of the partnership to Dillon Jones for \$900 (the FMV of the assets excluding cash). The partnership will use the \$900, plus the \$50 cash, to pay down the \$300 liabilities, leaving \$650 net before-tax proceeds to the partnership. **Figure 3.17** calculates the gain passed through to the partners from the sale of the partnership assets.

There is no entity-level tax on the gain, and the income is reported on the partners' returns. If the underlying assets are capital gain property, then the gain passes through as capital gain. Here we assume that the sale of the equipment and inventory is taxed at a 25% ordinary income tax rate.

Windsor and Ryan pay ordinary income tax on the \$400 passed-through gain. Assuming a 25% rate (and no NIIT), their personal tax liability is \$100 ($\$400 \times 25\%$). After-tax proceeds to the owners are \$550 ($\$650 - \100 taxes due).

Dillon may form a new business entity to hold the purchased assets, which have a basis equal to the purchase price (FMV).

Allocating Part of Sale Price to Personal Goodwill

The same personal goodwill sale opportunity illustrated earlier is available to a partnership. However, a partnership selling partnership-level goodwill has the same result. Therefore, it is customary in a partnership sale to not separate goodwill.

FIGURE 3.17 Sale of Partnership Interest or Assets

Gain on Partners' Returns	Basis	Sales Proceeds	Partners' Gain
Accounts receivable	\$ 200	\$ 200	\$ 0
Inventory	200	400	200
Equipment	100	300	200
Total	<u>\$ 500</u>	<u>\$ 900</u>	<u>\$ 400</u>
Proceeds from Sale of Entity/Assets			
Beginning cash			\$ 50
Sales proceeds			900
Liabilities paid			(300)
Net cash to distribute in liquation			<u>\$ 650</u>
Gain Pass-Through	Windsor	Ryan	Total
Proceeds from sale of entity/assets	\$ 390	\$ 260	\$ 650
Basis in entity (increased by gain pass-through)	(390)	(260)	(650)
Taxable gain	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>
Gain pass-through	<u>\$ 240</u>	<u>\$ 160</u>	<u>\$ 400</u>