SUMMARY OF SPECIFIC DEDUCTIONS

EXHIBIT 8.3

Bad debts	If business debt and accrual method taxpayer, ordinary loss If personal, specific write off and short-term capital loss
Worthless securities	Assumed worthless at year-end of realization
Section 1244 stock	$100,000 ordinary loss for married filing jointly, excess is capital loss ($50,000 for single filers)
Losses of individuals	Not deductible except as casualty loss
Research and experimental expenditures	In year paid, amortized over 60 months, or capitalized
Net operating losses	Generally, back 2 and forward 20 years, can elect forward only (exceptions exist)
Depreciation	Ratably written off

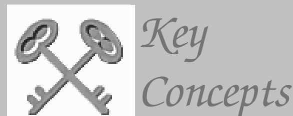
PENALTIES

In addition to the penalties that may be incurred for failure to file an income tax return, failure to pay the tax due, and taking unreasonable positions on returns or in tax court actions, three additional penalties apply directly to pension plan and IRA contributions and accumulations: the excess contributions penalty, the early distribution penalty, and the late distribution penalty.

RETIREMENT PLAN PENALTIES

EXHIBIT 8.4

- Excess Contributions
- Early Distributions
- Late Distributions



Key Concepts

Underline/highlight the answers to these questions as you read:

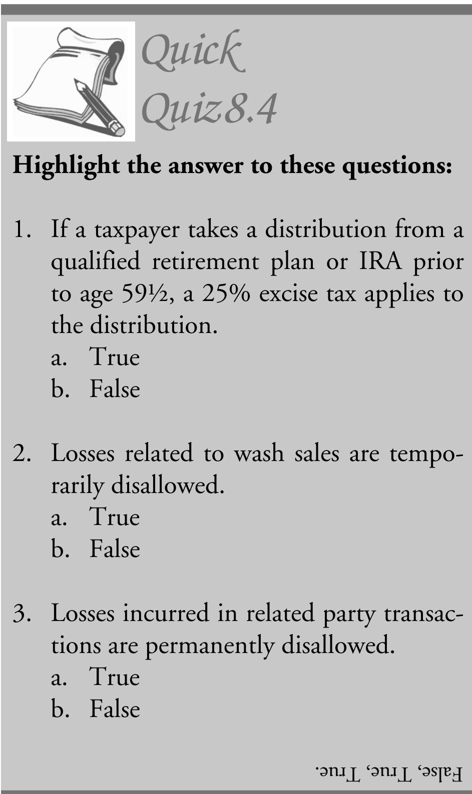
1. Describe the penalties applicable to pension plan and IRA contributions and distributions.
2. Describe the two types of temporary loss disallowance.
3. Describe the three types of permanent loss disallowance.

EXCESS CONTRIBUTIONS PENALTY

While Congress views saving for retirement as a worthy goal, contributing too much to retirement plans can generate a tax penalty. Retirement plans and IRAs give the taxpayer the ability to make tax-deductible contributions to the plan that directly reduces the taxpayer's taxable income in the current tax year. To prevent taxpayers from contributing excessive amounts to pension plans and IRAs in an effort to avoid current tax liability, Congress has set contribution limits that vary based on the type of pension plan or IRA being used. Under IRC Section 4973(a), excess contributions made to pension plans or IRAs will be subject to a six

percent excise tax, and the excess contribution must be distributed from the plan. Typically, the excess contribution amount is applied to the subsequent year contribution instead of forcing a distribution from the plan. To avoid the imposition of the six percent excise tax, the taxpayer should withdraw the excess (or allocate it to the contribution for the next tax year) by the due date of their income tax return, including extensions. Any withdrawal to reverse out an excess contribution must include the income earned on the excess contribution while inside of the retirement account or IRA, so taxpayers should take action quickly to avoid potential income taxation on additional growth.

Employers sponsoring certain types of retirement plans, such as SEPs, SIMPLEs, 401(k)s, defined contribution profit sharing plans and defined benefit plans, are subject to a ten percent excess contributions penalty unless exceptions apply.



Quick Quiz 8.4

Highlight the answer to these questions:

1. If a taxpayer takes a distribution from a qualified retirement plan or IRA prior to age 59½, a 25% excise tax applies to the distribution.
   a. True
   b. False

2. Losses related to wash sales are temporarily disallowed.
   a. True
   b. False

3. Losses incurred in related party transactions are permanently disallowed.
   a. True
   b. False

False, True, True.

EARLY DISTRIBUTION PENALTY

Due to the tax benefits (a tax deduction and tax-deferral) received for contributions to pension plans and IRAs, Congress wants to encourage taxpayers to use the plan for its intended purpose – funding retirement. If the taxpayer takes a distribution from a qualified retirement plan or IRA prior to age 59½, a 10 percent excise tax applies to the distribution. The 10 percent excise tax is imposed in addition to any tax incurred due to the inclusion of the distribution in the taxable income of the taxpayer. A special early distribution penalty applies to SIMPLE plans. If an early distribution is taken from a SIMPLE plan within two years of the date the taxpayer first participated in the plan, a 25 percent penalty applies to the distribution in addition to the regular income tax liability incurred as a result of the distribution.

There are several exceptions to the 10 percent early distribution penalty. Whether or not a particular exception applies depends on the type of plan from which the distribution is made. Some exceptions apply to qualified plans only, some to qualified plans and IRAs, and some to IRAs only.

There are three exceptions to the early distribution penalty that apply only to qualified plans:

1. Distributions to an employee who separates from service and has attained the age of 55;
2. Public safety employee separated from service after age 50; and
3. Distributions made in accordance with a Qualified Domestic Relations Order (QDRO) or state order distribution under divorce (which splits plan benefits in the event of a divorce).

Qualified plan participants who take advantage of early retirement can begin to take distributions from the plan (on separation from service) at 55 without fear of the early distributions penalty.

Three exceptions to the early distribution penalty apply only to IRAs. These include:

1. Distributions to pay for health insurance for unemployed taxpayers;
2. Distributions to pay for qualified higher education expenses of the taxpayer, spouse, or dependents; and
3. Distributions of up to $10,000 (lifetime maximum) for the first-time purchase of a home. A first-time home buyer is defined as a person who had not owned a home in the prior two tax years.

The remaining exceptions apply to both qualified plans or IRAs. These exceptions include:

1. Substantially equal periodic distributions under IRC Section 72(t);
2. Distributions made as a result of the disability of the taxpayer;
3. Distributions made by reason of the death of the taxpayer;
4. Distributions necessary to cover unreimbursed medical expenses that exceed 7.5 percent of the taxpayer's AGI; and
5. Distributions due to an IRS levy to collect taxes due.

SUMMARY OF 10 PERCENT PENALTY EXCEPTIONS FOR QUALIFIED PLANS AND IRAS — EXHIBIT 8.5

Applies to Distributions from:	Exception to 10% Early Withdrawal Penalty
Both Qualified Plans & IRAs	Death
Both Qualified Plans & IRAs	Attainment of age 59½
Both Qualified Plans & IRAs	Disability
Both Qualified Plans & IRAs	Substantially equal periodic payments (Section 72(t))
Both Qualified Plans & IRAs	Medical expenses that exceed 7.5% of AGI
Both Qualified Plans & IRAs	Tax levy
Only Qualified Plans	QDRO or state order under divorce*
Only Qualified Plans	Attainment of age 55 and separation from service
Only Qualified Plans	Public safety employee separated from service after age 50
Only IRAs	Higher education expenses
Only IRAs	First time home purchase (up to $10,000)
Only IRAs	Health insurance for unemployed

*Where there is a distribution at divorce and the payee is under 59½, the use of a QDRO directed distribution will result in a taxable event but will not incur the 10% early withdrawal penalty. Under the same circumstances, except that the distribution is from an IRA, the result is both a taxable event and the application of the 10% early withdrawal penalty. However, the payee in any case can choose to rollover the distribution in which case, the rollover rules would apply or the payee can take substantially equal periodic payments under Section 72(t).

Late Distribution Penalty

Congress views late distributions from pension plans and IRAs as a more serious problem than early distributions or excess contributions to plans, since late distributions defer the taxation of plan benefits. Individuals who are required to take distributions from retirement plans and IRAs (due to the imposition of the required minimum distribution rules) but fail to do so are subject to a 50 percent excess accumulation penalty. The required minimum distribution rules (RMDs) are found in Treasury Regulations 1.401(a)(9) and 1.408-8. Additional information on RMDs may also be obtained in IRS Publication 590, available at www.irs.gov. Minimum distributions are required by April 1 of the year following the year in which the taxpayer reaches age 70½. The excess accumulation penalty may be waived if the taxpayer received erroneous advice from an advisor to the pension plan, or if the taxpayer can demonstrate that he or she acted in good faith when attempting to apply the RMD rules.

OTHER LOSS DISALLOWANCES – TEMPORARY AND PERMANENT

There are a number of other types of losses that may be either temporarily or permanently disallowed. Each of the following types of losses is discussed more extensively later in this text, but it is appropriate to mention them briefly in this chapter. The following chart references the chapter in which a full discussion of each of these topics can be found.

Exhibit 8.6 Loss Disallowance Cross References

Section 1031 Exchanges	Chapter 13
Wash Sales	Chapter 11
Related Party Transactions	Chapter 11
Gifts Below FMV	Chapter 11
Sale of Personal Assets	Chapter 11

Section 1031 Exchanges Resulting in a Loss are Not Immediately Deductible

When like-kind assets are exchanged under Section 1031, no gain or loss is recognized in the transaction. The loss is not permanently disallowed; it is deferred and increases the basis of the new asset.

Example 8.19

John and Jeff exchange like-kind machines in a transaction that qualifies for nonrecognition under Section 1031. John's machine is worth $17,000 and he has an adjusted basis of $18,000. Jeff's machine has a fair market value of $14,000 and he pays John cash of $3,000 in the exchange. John's realized loss is $1,000 ($17,000 amount realized - $18,000 adjusted basis). The loss is not deductible but John's new basis in Jeff's old machine

is $15,000 ($18,000 - $3,000 cash = $15,000) and the fair market value of the new asset is $14,000. If John sells the new asset immediately he will have a $1,000 loss.

WASH SALES

When a taxpayer sells stock at a loss, and purchases substantially identical securities within 30 days before or after the sale, the taxpayer has participated in a wash sale and cannot recognize any loss from the sale of the stock. Note that this loss disallowance is temporary and the full benefit of the loss may still be recognized at a future date.

EXAMPLE 8.20

Five years ago, Jay bought 80 shares of Bicycle Corp. at $50 per share. The stock has declined to $30, and Jay decides to sell it to take the loss deduction. Soon after, Jay sees some good news on Bicycle Corp. and buys it back for $32 approximately two weeks after he sold his original stock. Jay cannot deduct his loss of $20 per share. However, Jay does add $20 per share to the basis of his replacement shares. Those shares have a basis of $52 per share: the $32 Jay paid, plus the $20 wash sale adjustment. In other words, Jay is treated as if he bought the shares for $52. If Jay ends up selling the shares for $55, he will only report $3 per share of gain. In the alternative, if Jay later sells the shares for $32 (the same price he paid to buy them), he will report a loss of $20 per share.

RELATED PARTY TRANSACTIONS

Unlike the losses from Section 1031 exchanges and wash sales, losses incurred in related party transactions are permanently disallowed. When property is sold at a loss to a related party, the seller may not recognize any loss on the sale.

A related party includes the taxpayer's spouse, lineal descendants and ascendants, and siblings (both whole and half bloods). Therefore, related parties does not include: nieces, nephews, aunts, uncles, cousins, step-children, parents-in-law, step-parents, or step-parents-in-law.

EXAMPLE 8.21

Laura owns 100 shares of CityCo stock, which have a fair market value of $20 per share. Laura sells all 100 shares to her sister Jill for $15 per share. Although Laura has realized a loss of $5 per share, she is not allowed to recognize this loss and it is permanently disallowed.

The **double basis rule** is also applied to the transferee. The double basis rule applies to certain related party transactions and to certain gift transactions. The purpose of the rule is to discourage the transfer by sale or gift to related parties or those to whom the taxpayer

would make gifts of property which at the time of the transfer has a fair market value less than the transferors adjusted taxable basis.

In the above example, Jill will have a basis of $15 for future losses but a second (thus, double) basis of $20 for gains. If Jill later sells the stock for $21, she will have a gain of $1. If instead, she were to sell the stock for $13, she would have a $2 loss. If she sold the stock at a price between the gain basis and the loss basis, she would have no gain or loss. In addition, the double basis rule applies to gifts where the fair market value of the gift is below the donor's (transferor) adjusted taxable basis. The holding period will be discussed in Chapter 11.

Gifts Below Fair Market Value

Like related party transactions, certain gifts will result in the permanent disallowance of a loss. When gifted property has a fair market value that is less than the donor's adjusted basis, the double basis rule applies, meaning that the donee has one basis for gains (the donor's original basis) and another basis for losses (the value of the property on the date of the gift). If the gifted property is subsequently sold by the donee for less than the fair market value on the date of the gift, part of the loss is permanently disallowed.

Example 8.22

Susan purchased CatCo stock several years ago for $40 per share. When the stock price fell to $30 per share, Susan decided to gift the stock to her friend Marshall. Under the double basis rule, Marshall's basis will be $30 for losses and $40 for gains. If Marshall subsequently sells the stock for $25 per share, he will recognize a loss of $5 per share. However, the loss that occurred while Susan owned the stock ($40 - $30 = $10 per share) will be permanently disallowed.

Sale of Personal Assets for Loss

When personal assets are sold at a loss, that loss may not be recognized. Rather, in order for a loss on the sale of an asset to be recognizable, that asset must be used for the production of income in a trade or business. If a loss is disallowed because the asset is a personal asset, the loss is permanently disallowed and the taxpayer may not recognize it at any point in the future.

Exhibit 8.7

Summary of Disallowed Losses

Temporarily Disallowed	Permanently Disallowed
• Section 1031 exchanges • Wash sales	• Related party transactions • Gifts below fair market value • Sale of personal assets at a loss