Individual Retirement Accounts

Traditional IRAs

In addition to the use of company-sponsored retirement plans, taxpayers can also save for retirement by making contributions to Individual Retirement Accounts. Some taxpayers can make tax deductible contributions to traditional IRAs, while others may not. All taxpayers making traditional IRA contributions, however, receive the benefit of tax-deferred growth. The earnings generated on traditional IRA investments are not subject to income taxation until they are withdrawn from the account, which will presumably occur on or after the date of the taxpayer's retirement. Penalty free distributions may be made after the age of 59½. Furthermore, distributions must begin by April 1 of the year following the year the taxpayer attains age 70½ (for those who reached age 70½ by December 31, 2019), or a penalty tax will be assessed. Under the SECURE Act of 2019, Congress extended the age at which minimum distributions must begin to age 72 (from age 70½ under prior law). Individuals who had not reached the age of 70½ by December 31, 2019 will not have to begin taking distributions until April 1 of the year following the year they turn age 72. Individuals who had attained age 70½ by December 31, 2019 must continue to take required minimum distributions in order to avoid a tax penalty.

Key Concepts

1. Describe the circumstances under which an individual can make a contribution to a traditional and Roth IRA.
2. Explain the limits on the deductibility of a contribution to a traditional IRA.
3. Discuss the active participant rules for contributions made to a deductible traditional IRA.
4. Explain under what circumstances a non-active participant spouse can contribute to a deductible traditional IRA.

Contributions

Those taxpayers who qualify for an income tax deduction on contributions to a traditional IRA may take that deduction as an adjustment to income. The maximum allowable contribution to a traditional IRA is $6,000 for 2020. Taxpayers age 50 and older can make an additional $1,000 catch-up contribution. If the taxpayer has both a traditional and a Roth IRA, the maximum contributed to both accounts is aggregated and may not exceed these limits.

To make a contribution to a traditional IRA, the taxpayer must have earned income. The maximum allowable contribution to a traditional IRA in any one tax year is the lesser of the taxpayer's earned income or the contribution limit (including the catch-up amount) set forth by law. If a taxpayer is married and has a non-working spouse, a spousal IRA can be set up and the same amounts can be contributed to the spousal IRA even if the spouse does not have any earned income and the working spouse has sufficient earned income to cover both contributions.

Contributions to traditional IRAs that are in excess of the allowable amount are subject to a six percent penalty. In addition, contributions must be made by the tax-filing deadline for the year, usually April 15, (not including extensions).

Deductibility of Contributions

Traditional IRA contributions are fully deductible each year for all individuals who are not active participants in qualified retirement plans. This rule is modified, however, when a spousal traditional IRA is created, and one spouse is an active participant while the other is not.

Active participants in retirement plans may still be able to make tax-deductible contributions to an IRA provided that their adjusted gross income does not exceed specified limits. An "active participant" in a defined contribution pension plan is any person who contributes to the plan (in a cash or deferred arrangement) or who receives an allocation from the employer for the plan year (including forfeitures). Any employee eligible to participate in a defined benefit plan is also considered to be an active participant, even if he or she declines to be covered by the plan.

Once an individual is considered an active participant in a retirement plan, deductible traditional IRA contributions are phased out over specified AGI ranges. The AGI ranges for 2020 are shown in **Exhibit 6.5 | Who Can Deduct Contributions to a Traditional IRA**.

The deductibility threshold for a traditional IRA is increased for a non-active participant spouse. For purposes of determining the non-active participant spouse's IRA deduction, the AGI phaseout range is \$196,000 - \$206,000 (2020). To qualify for this increased phaseout range, the spouses must be filing their income tax return jointly.

Those with an AGI below the lower limit can make a fully deductible traditional IRA contribution. The deductibility of the contribution is phased out for AGI between the noted limits. Once the taxpayer has income equal to or in excess of the upper limit, no deductible IRA contribution can be made.

Exhibit 6.5 | Who Can Deduct Contributions to a Traditional IRA

<table>
<tr><th>Taxpayer is not an active participant</th><th colspan="2">Taxpayer(s) is an active participant</th><th>One spouse is an active participant, while the other spouse is not</th></tr>
<tr><td rowspan="4">No AGI Limit</td><td rowspan="2">Single</td><td>AGI Phaseout</td><td rowspan="4">The spouse who is not an active participant may have a deductible traditional IRA contribution as long as their joint AGI does not exceed $206,000 (2020). The deductible IRA contribution is phased out between $196,000 - $206,000 for 2020.</td></tr>
<tr><td>$65,000 - $75,000 (2020)</td></tr>
<tr><td rowspan="2">MFJ</td><td>AGI Phaseout</td></tr>
<tr><td>$104,000 - $124,000 (2020)</td></tr>
</table>

Example 6.2

Ryan, a recent college graduate, had AGI this year of \$45,000. Ryan is single, and has no dependents. If Ryan made a contribution of \$6,000 to a traditional IRA this year, he would be able to deduct the entire contribution, since his AGI is below the phaseout threshold.

Example 6.3

Liam, a single individual, has AGI of \$70,000. If Liam makes a contribution to a traditional IRA in 2020, he will be able to deduct \$3,000 (since Liam's AGI is exactly half way through the phaseout range, he can only deduct 50% of the otherwise allowable amount, or \$3,000). The first \$3,000 of the IRA contribution could be made to a traditional IRA, but if Liam wishes to make additional contributions, the additional amounts (up to another \$3,000) should be made to a Roth IRA.

$$\text{Reduction} = \text{Contribution Limit} \times \frac{\text{AGI} - \text{Lower Limit}}{\text{Phaseout Range}}$$

$$2020 = \$6{,}000 \times \frac{(\$70{,}000 - \$65{,}000)}{\$10{,}000} = \$3{,}000$$

The phaseout range for tax deductibility of IRA contributions for married filing jointly taxpayers is twice the phaseout range for single individuals. Therefore, the phaseout reduction calculation for married filing jointly is as follows:

$$\text{MFJ Reduction} = \text{Contribution Limit} \times \frac{\text{AGI} - \text{Lower Limit}}{\$20{,}000}$$

Example 6.4

Chris and Kelly, both age 35, are married and filed a joint return for 2020. Chris earned a salary of $135,000 in 2020 and is covered by his employer's 401(k) plan. Chris and Kelly earned interest of $15,000 in 2020 from a joint savings account. Kelly is not employed, and the couple had no other income. On April 15, 2021, Chris contributed $6,000 to an IRA for himself and $6,000 to an IRA for Kelly. The maximum allowable IRA deduction on the 2020 joint return is $6,000. Chris will not be permitted to make a tax deductible IRA contribution for the year, since he is an active participant in his employer's plan and the couple's AGI for the year exceeds the phaseout threshold. Kelly, however, will be permitted to make a tax-deductible traditional IRA contribution since she is not an active participant in a qualified plan, and the couple's AGI fell below the increased threshold (that applies to non-participant spouses) of $196,000 (2020). Since Chris cannot make a tax-deductible traditional IRA contribution, and the AGI on his tax return this year falls below $196,000 (the lower end of the Roth IRA phaseout range), Chris should place his IRA contribution in a Roth IRA because he will get tax-free compounding and tax-free distributions in the Roth. Kelly should consider whether her IRA contribution should be made to a Roth IRA as well, but if they want the current income tax deduction they will make Kelly's contribution to a traditional IRA.

Taxpayers who cannot make income tax-deductible contributions to a traditional IRA may still make nondeductible contributions to nondeductible IRAs to achieve the tax benefits of income tax deferral on the earnings growth. Those electing to do this should file Form 8606 each year to keep track of their adjusted basis in the IRA so that the basis can be distributed to them tax-free when distributions begin.

Roth IRAs

A better alternative than a nondeductible IRA for many taxpayers above the traditional IRA phaseout range but below the Roth IRA phaseout range (**Exhibit 6.6 | Roth IRA Phaseouts**) is to make IRA contributions to a Roth IRA. Contributions made to a Roth IRA are not deductible, but the growth and withdrawals are tax-free for qualified distributions made after the age of 59½. Roth IRAs do not have required mandatory distributions, therefore unlike traditional IRAs, there is no penalty tax on insufficient withdrawals after age 70½ (for those who reached age 70½ by the end of 2019) or age 72 (for those who turned 70½ after December 31, 2019).

Contributions

The maximum allowable contribution to a Roth IRA is $6,000 for 2020. Taxpayers age 50 and older can make an additional $1,000 catch-up contribution. As stated previously, if the taxpayer has both a traditional and a Roth IRA, the maximum contributed to both accounts is aggregated and may not exceed these limits.

As is the case with a traditional IRA, in order to make a contribution to a Roth IRA, the taxpayer must have earned income. The maximum allowable contribution to a Roth IRA in any one tax year is the lesser of the taxpayer's earned income or the contribution limit (including catch-up amount) set forth by law. If a taxpayer is married and has a non-working spouse, a spousal IRA can be set up and the same amounts can be contributed to the spousal IRA even if the spouse does not have any earned income as long as the working spouse has sufficient earned income.

Contributions to Roth IRAs that are in excess of the allowable amount are subject to a six percent penalty. In addition, contributions must be made by the tax-filing deadline for the year (not including extensions).

The 2020 AGI phaseout ranges for Roth IRAs are identified in **Exhibit 6.6 | Roth IRA Phaseouts**.

Quick Quiz 6.3

1. An unmarried taxpayer can make a contribution to an IRA, even if he does not have earned income.
   a. True
   b. False
2. Active participation in a retirement plan does not affect the deductibility of a traditional IRA.
   a. True
   b. False
3. The deductibility threshold for a traditional IRA is increased for a non-active participant spouse.
   a. True
   b. False
4. Contributions to traditional and Roth IRAs that are in excess of the allowable amount are subject to a 4% penalty.
   a. True
   b. False

False, False, True, False.

The phaseout ranges for single taxpayers and for married taxpayers filing jointly are increasing each year, but the phaseout range for those married filing separately is static. Distributions from Roth IRAs will be tax-free if the account has been open for at least five years and the distribution occurs after the taxpayer reaches age 59½. Distributions meeting their two requirements are referred to as qualified distributions.

Exhibit 6.6 | Roth IRA Phaseouts

Filing Status	2020
Single	$124,000 - $139,000
Married Filing Jointly	$196,000 - $206,000
Married Filing Separately	$0 - $10,000

Moving Expenses

Moving expenses were deductible for tax years before 2018, and will be deductible for tax years after 2025. TCJA 2017 suspended the deduction for qualified moving expenses and the exclusion for qualified moving expense reimbursements for tax years beginning in 2018 and ending in 2025.

Under the provisions of TCJA 2017, there is only one exception to the suspension of the deduction/exclusion of moving expenses. Active duty members of the Armed Forces (or their spouse or dependents) who move pursuant to a military order and incident to a permanent change of duty station may deduct qualified moving expenses and may exclude from income amounts attributable to in-kind moving and storage expenses, including reimbursements or allowances for these expenses.

Moving expenses that can be deducted (before 2018 and after 2025, as well as for active duty members of the Armed Forces) include costs associated with moving household goods and personal effects, storage of these items while in transit, and travel expenses for one trip by the taxpayer and members of the household. Expenses that cannot be deducted include meals during travel (these are considered personal expenses), the expenses of buying or selling a home (these expenses are either added to basis or subtracted from the amount realized in a sale transaction), temporary living expenses, and house-hunting expenses. The deduction is available to those moving due to a change in employment with an existing or new employer, but in either case, it must involve full-time employment at the new location.

To qualify for a moving expense deduction, a **distance test** must be met. The distance between the old home and the new job location must be at least 50 miles greater than the distance between the old home and the old job location. Recognize that it is not important where a taxpayer moves to, only that the distance test is met.

Penalty on Early Withdrawal of Savings

Penalties paid on early withdrawal of savings are deductible as an adjustment to income. Typically, penalties are imposed when an individual who has a Certificate of Deposit with a bank cashes in that certificate early. The penalty constitutes a forfeiture of interest. Under the doctrine of constructive receipt, money set aside for a taxpayer is taxable to the taxpayer in the year it is credited to their account, not the year the taxpayer receives the interest payment. Often, a CD can be purchased for a greater than one year maturity, in which case the bank will send the taxpayer a Form 1099 at the end of each year indicating the amount of interest that has been credited to the taxpayer's account, and the taxpayer must include that amount in their income tax return for that year, and pay tax on the interest. The allowance of a deduction for a penalty on the early withdrawal of savings simply reverses the inclusion of interest income on the CD when it is cashed in early. The penalty must be reported as an adjustment to income, however, and cannot be used to directly offset interest income in the gross income section of the tax return (including the interest reported by the bank on a CD that was cashed in early).

Educator Expenses

Teachers in elementary and secondary schools (grades Kindergarten through 12th grade), principals, aides, and counselors may deduct up to $250 (2019 and 2020) of out-of-pocket expenses paid as an adjustment to gross income (on Schedule 1 of Form 1040).[1] In tax years before 2018 and after 2025, expenses that can be deducted include items such as books, supplies, computers, computer equipment, and materials used in the classroom. To qualify for the deduction, an individual must have spent more than 900 hours during a school year as a K-12 educator. Expenses in excess of the $250 above-the-line maximum may be deducted below-the-line, as an

Key Concepts

1. Explain who is entitled to deduct student loan interest incurred on qualified student loans.
2. Describe the requirements for classifying a payment as alimony.
3. Explain the consequences of alimony recapture.

1. The $250 is indexed.

unreimbursed employee business expense (a miscellaneous itemized deduction subject to the two percent floor, which will be discussed in the next chapter).

Student Loan Interest

Up to $2,500 of student loan interest incurred on qualified student loans may be deducted as an adjustment to gross income. The deduction is available for interest on loans for the benefit of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent that were incurred while the student was either the taxpayer, a spouse, or a dependent. To be eligible for the deduction, the taxpayer must have a primary obligation to repay the debt, and must actually make interest payments during the year (deferred interest payments are not deductible until they are paid, since all individuals are cash-basis taxpayers).

Exhibit 6.7 | Deductibility of Student Loan Interest

Loan Made By	Loan Repaid By	Is it deductible?
Parent	Parent	Yes
	Student	No
Student	Parent	No
	Student	Yes

The ability to deduct student loan interest is phased-out for higher income taxpayers, and the phaseout range is indexed for inflation. Individuals with modified adjusted gross income (MAGI) below the lower limit may take a deduction for student loan interest up to $2,500. The deduction is phased out ratably over the phaseout range, and once MAGI reaches the upper limit, no deduction for student loan interest is permitted. Modified adjusted gross income (MAGI) for purposes of determining the student loan interest deduction phaseout is calculated by taking the taxpayers AGI and adding back the foreign earned income exclusion plus the income exclusion for certain U.S. Possessions and Puerto Rico, as well as the deductions taken for tuition and fees. Qualified production activities include manufacturing, producing, growing, and extracting tangible personal property, computer software, and sound recordings, and the construction and substantial renovation of real property including infrastructure.

Exhibit 6.8 | Student Loan Interest Deductible Phaseout (2020)

Filing Status	2020
Single	$70,000 - $85,000
Married Filing Jointly	$140,000 - $170,000
Married Filing Separately	$0

Married individuals filing separately and dependents are not eligible to take the student loan interest deduction.

In order to be deductible, the interest must have been incurred on a qualified education loan. A qualified education loan is one that is taken out to cover qualified education expenses, which include tuition, fees, books, equipment, transportation and room and board incurred to attend a post-secondary school or college eligible to participate in the Department of Education student loan programs.

To the extent that educational expenses are paid with pre-tax or tax-free benefits, such as with distributions from Section 529 plans, series EE or I Savings Bonds, or employer provided and veterans educational benefits, qualified education expenses must first be reduced by these amounts before determining the amount of interest that is deductible under the Student Loan interest deduction. The SECURE Act of 2019 expanded the definition of qualified education expenses for 529 plan distributions to include up to $10,000 (lifetime maximum) to repay student loans. When tax-free distributions are made from a 529 plan to repay student loans, the otherwise deductible amount for student loan interest is reduced by the amount of interest paid from a tax-free distribution from a 529 plan.

Furthermore, the loan must have been incurred for an individual who was at least a half-time student (a student who maintained a credit load of at least one-half of the normal full-time credit load).

Qualified Tuition and Related Expenses

The Taxpayer Certainty and Disaster Tax Relief Act allows an above-the-line deduction for qualified tuition and related expenses for tax years beginning after December 31, 2017 and before January 1, 2021. The amount of the deduction is limited to $4,000 for taxpayers with AGI below $65,000 ($130,000 for married filing jointly), and limited to $2,000 for taxpayers with AGI between $65,000 and $80,000 (between $130,000 and $160,000 for married filing jointly). For taxpayers with AGI above $80,000 ($160,000 for married filing jointly) and taxpayers filing as married filing separately, no deduction is available.

Exhibit 6.9 | Deduction Limit for Qualified Tuition and Related Expenses

Filing Status	AGI	Maximum Deduction
Single	Up to $65,000	$4,000
MFJ	Up to $130,000	
Single	Over $65,000 - $80,000	$2,000
MFJ	Over $130,000 - $160,000	
Single	Over $80,000	$0
MFJ	Over $160,000	
MFS	Over $0	

Qualified expenses include tuition and fees required for the enrollment of the taxpayer, spouse, or dependent of the taxpayer at an eligible higher education institution. The qualified expenses must be reported by the eligible institution to the taxpayer and the IRS on Form 1098-T.

A taxpayer who takes the above-the-line deduction for tuition and related expenses cannot also take an American Opportunity or Lifetime Learning tax credit (discussed in chapter 9) for the same expenses. If tax-free distributions are made from an Education Savings Account, 529 plan, or Series EE or I Savings Bonds to pay for qualified expenses, the taxpayer cannot also take a deduction for the same expenses.

Exhibit 6.10 | Form 1098-T

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FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone number		1 Payments received for qualified tuition and related expenses $ 2	OMB No. 1545-1574 2020 Form 1098-T	Tuition Statement
FILER'S employer identification no.	STUDENT'S TIN ☐	3		Copy A For Internal Revenue Service Center
STUDENT'S name		4 Adjustments made for a prior year $	5 Scholarships or grants $	File with Form 1096.
Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code		6 Adjustments to scholarships or grants for a prior year $	7 Check this box if the amount in box 1 includes amounts for an academic period beginning January–March 2021 ☐	For Privacy Act and Paperwork Reduction Act Notice, see the **2020 General Instructions for Certain Information Returns.**
Service Provider/Acct. No. (see instr.)	8 Check if at least half-time student ☐	9 Check if a graduate student ☐	10 Ins. contract reimb./refund $	

Form 1098-T Cat. No. 25087J www.irs.gov/Form1098T Department of the Treasury - Internal Revenue Service

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Alimony Paid

For divorce decrees entered on or before December 31, 2018, alimony payments are deducted from the income of the payor (as an adjustment to income, or above-the-line deduction), and included in the income of the former spouse receiving the payment (the payee). When treated in this manner, Alimony receives pass-through tax treatment - the person who winds up with the cash has to pay the tax.

TCJA 2017 repealed the deduction by the payor for payment of alimony, and the inclusion in income by the payee, for alimony decrees that are entered into after December 31, 2018. If alimony decrees entered into before January 1, 2019 are substantially modified and the modification specifically states that the rules set forth in TCJA 2017 apply, the income tax deduction for the payor and the income tax inclusion for the payee is also repealed.

After 2018, a financial professional may have some clients who follow the traditional alimony rules (deduction for the payor; inclusion for the payee), and others who are subject to the repeal of the traditional rules (no deduction for the payor; no inclusion for the payee). Those clients subject to the repeal of the rules have clear tax treatment - no deduction is permitted for the payor, and no inclusion is required for the payee. Clients who are not subject to the repeal of the traditional alimony rules under TCJA 2017 are subject to the tax treatment specified below.

Quick Quiz 6.4

1. If an employer reimburses an employee for moving expenses, the employee may not claim a deduction based on the same expenses.
   a. True
   b. False
2. Temporary living expenses may be deducted by an employee as moving expenses.
   a. True
   b. False
3. Educator expenses in excess of $250 are not deductible below the line for tax years 2018-2025.
   a. True
   b. False
4. Alimony recapture is only an issue if alimony payments increase during the first three post-separation years.
   a. True
   b. False

True, False, True, False.