Notice 87-16, I.R.B. 1987-5.

The Tax Reform Act of 1986 (the Act) substantially modified the provisions of the Internal Revenue Code relating to Individual Retirement Arrangements (IRAs). Specifically, provisions of the Act reduce and, in some cases, eliminate deductions for IRA contributions, allow nondeductible IRA contributions, and change some of the current rules concerning collectibles and spousal IRAs. In general, these provisions are effective for taxable years beginning after December 31, 1986.

This Notice provides guidance concerning these provisions, and, until applicable regulations are published, taxpayers may rely on the guidance provided in this Notice to resolve the issues which are specifically considered. However, some issues related to the treatment of IRAs are not addressed in this Notice. No conclusions should be drawn with respect to these issues or the reasons for their exclusion from this Notice.

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I. *Deductible Contributions to IRAs*

A. *Active Participant Status*

An individual who is not an active participant in a retirement arrangement specified in section 219(g)(5) of the Code may make a deductible IRA contributin for the taxable year of up to the lesser of $2,000 ($2,250 for spousal IRAs) or 100% of compensation. An individual who is married and files a joint federal income tax return will be treated as an active participant if such individual's spouse is an active participant.

Section 219(g) of the Code provides that if an individual is an active participant in such a retirement arrangement for a taxable year, the $2,000 ($2,250 for spousal IRAs) dollar limit on the individual's deduction may be reduced or eliminated for such year. Accordingly, the first step in determining the permissible IRA deduction for a year is to determine active participant status for the taxable year.

For purposes of the IRA deduction rules, an individual shall be an “active participant” for a taxable year if either the individual or the individual's spouse (with whom the individual files a joint tax return) actively participates in any of the following:

(1) a qualified plan described in section 401(a) of the Code,

(2) an annuity plan described in section 403(a) of the Code,

(3) a plan established for its employees by the federal, state or local government or by an agency or instrumentality thereof (other than a plan described in section 457 of the Code),

(4) an annuity contract or custodial account described in section 403(b) of the Code,

(5) a simplified employee pension described in section 408(k) of the Code, or

(6) a trust described in section 501(c)(18) of the Code.

See Questions A1 through A14 for active participant rules that apply to all plans.

In determining when an individual is an active participant in a retirement arrangement for a taxable year, different rules are applied, depending upon whether the retirement arrangement is a defined benefit or a defined contribution plan.

Defined Benefit Plan Rule

In the case of a defined benefit plan, an individual who is not excluded under the eligibility provisions of the plan for the plan year ending with or within the individual's taxable year shall be an active participant in the plan, regardless of whether such individual has elected to decline participation in the plan, has failed to make a mandatory contribution specified under the plan or has failed to perform the minimum service required to accrue a benefit under the plan. For example:

> An individual is a calendar year taxpayer who is not excluded from participation under the provisions of a defined benefit plan with a July 1 to June 30 plan year. The individual separates from service on December 31, 1987. Because the individual is not excluded under the plan's eligibility provisions for the plan year ending in such individual's 1988 taxable year, such individual shall be an active participant for the 1988 taxable year.

See Questions A15 through A18 for defined benefit plan active participant rules.

Defined Contribution Plan Rule

Generally, in the case of a defined contribution plan, an individual shall be an active participant if employer or employee contributions or forfeitures are allocated to such individual's account with respect to a plan year ending with or within the individual's taxable year. For example:

> Company B sponsors a money purchase pension plan with a plan year ending on June 30. The plan provides that contributions must be allocated as of the last day of the plan year. On December 31, 1987, an individual employed by the Company separates from service. The contribution for the plan year ending on June 30, 1988 is not made until February 15, 1989, when the Company files its corporate return. In this case, the individual is an active participant for such individual's 1988 taxable year.

A special rule applies to certain plans in which it is impossible to determine whether or not an amount (other than earnings) will be allocated to an individual's account for a given plan year. If, with respect to a particular plan year, no amount attributable to forfeitures, employer contributions or employee contributions has been allocated to an individual's account by the last day of the plan year, and contributions to the plan are purely discretionary for the plan year, such individual shall not be an active participant for the taxable year in which such plan year ends. If, however, after the end of such plan year, the employer contributes an amount for such plan year, an individual to whose account an allocation is made shall be an active participant for the taxable year in which the contribution is made.

Contributions shall be treated as purely discretionary for the plan year if, as of the end of the plan year, the employer is not obligated under the law or terms of the plan to make a contribution for the plan year, and whether or not contributions are made to the plan is ultimately dependent upon the employer's decision or factors within the control of the employer. Contributions are not purely discretionary merely beause they are dependent on profits. For example:

> An individual covered by a profit-sharing plan separated from service on December 31, 1987. The plan year runs from July 1 to June 30. Under the terms of the plan, employer contributions, if any, shall be made at the complete discretion of the Board of the Directors and shall be contributed to the plan prior to the due date for filing the employer's tax return. Such contributions are allocated as of the last day of the plan year, and allocations are made to the accounts of individuals who have any service during the plan year. As of June 30, 1988, no employer or employee contributions had been made that are allocated to the June 30, 1988 plan year, and no forfeitures had been allocated within the plan year. In addition, as of such date, the employer was not obligated to make a contribution for such plan year and it was impossible to determine whether or not a contribution would be made with respect to the plan year. On December 31, 1988, the Board of Directors agreed to contribute a specified amount to the plan, with respect to the plan year ending June 30, 1988; on February 15, 1989, such contribution was made to the plan. As a result of the amount allocated to such individual's account as of June 30, 1988, the individual is an active participant in the plan for the 1989 calendar year but not for the 1988 year.

See Questions A19 through A26 for the defined contribution plan rules.

General Active Participant Questions

A1: How will an employer report active participant status for a taxable year?

A: An individual's employer (or former employer) must inform an individual of active participant status for the taxable year of the individual. This status must be reported on a Form W-2.

A2: If an individual is not an active participant, but such individual's spouse is an active participant, will the individual be treated as an active participant?

A: If the couple files a joint federal income tax return for the applicable year, active participation by either spouse will cause both spouses to be treated as active participants. But see Question A3.

A3: If an individual is married but files a separate tax return, will active participation by his or her spouse affect the individual's active participant status?

A: No. Section 219(g)(4) of the Code provides that a married individual who files a separate tax return is considered single for purposes of determining active participant status. Thus, if the individual is not an active participant, the fact that his or her spouse is an active participant will not limit such individual's IRA deduction.

A4: If a married individual obtains a divorce during his or her taxable year (and does not remarry during such year), is the individual considered an active participant merely because the former spouse is an active participant for the year?

A: No. Marital status is determined as of the end of the year. Thus, if the individual is not married at the end of the year, the fact that his or her former spouse is an active participant will not cause the individual to be treated as an active participant. Similarly, if an individual marries during the year, and the individual's new spouse is an active participant, the individual shall be treated as an active participant for the entire year if the couple files a joint tax return.

A5: If a married individual dies during a taxable year and is an active participant for such taxable year, will the survivor be treated as an active participant for purposes of section 219(g) of the Code?

A: Yes. In the taxable year of death, active participation is determined as if the deceased spouse was still alive. Thus, if the deceased spouse was an active participant for the taxable year of death and a joint return is filed for the taxable year of death, the survivor will also be treated as an active participant. In such a case, the applicable dollar limitation for AGI purposes is $40,000. (See I. B., below.) For taxable years following the taxable year of death, the deceased spouse's status as an active participant in the year of death has no effect on the survivor's status as an active participant because the survivor is not treated as married to the deceased spouse for purposes of the active participation rules. However, for AGI purposes, in those cases in which the survivor meets the filing status requirements under section 2(a) of the Code, the survivor will use the same $40,000 applicable dollar limitation used by married taxpayers filing jointly.

A6: An individual has an amount deferred for a taxable year in a plan described in section 457 of the Code. Does participation in such a plan cause the individual to be an active participant?

A: No. Section 219(g)(5) of the Code specifically exempts unfunded deferred compensation plans described in section 457 of the Code from the definition of relevant plans for purposes of determining who is an active participant. Participation in any retirement plan established by a state or local government, other than a plan described in section 457 of the Code, is active participation for purposes of section 219(g)(5) of the Code.

A7: Is an individual who is covered under Social Security or Railroad Retirement (Tier I or Tier II) an active participant?

A: No. Under Section 219(g)(5), neither Social Security nor Railroad Retirement (Tier I and Tier II) is a retirement arrangement for purposes of determining active participant status.

A8: Is a retired individual who is receiving pension annuity payments an active participant?

A: No. An individual will not be treated as an active participant merely because the individual receives benefits under a retirement arrangement described in section 219(g)(5) of the Code.

A9: If an individual is ineligible for benefit accrual in a retirement plan that is integrated with Social Security solely because the compensation of that individual is below the integration level or because the full benefit will be offset by Social Security, is the individual an active participant?

A: No. In the case of a defined benefit plan, an individual who is not excluded under the eligibility provisions of the plan, but who is nonetheless ineligible to accrue a benefit under a plan because compensation is below the integration level or whose benefit will be fully offset by social security for the plan year ending with or within the taxable year, shall not be an active participant in such plan. (Note: This is an exception to the general rule applicable to defined benefit plans, and it is limited to the facts set forth in the preceding sentence.) Similarly, in a defined contribution plan, if an individual is ineligible for an allocation in a plan year because the individual's compensation is below the integration level, such individual shall not be an active participant for the taxable year with or within which such defined contribution plan year ends.

A10: Is an individual who makes employee contributions to a qualified plan described in section 219(g)(5) an active participant?

A: Yes. If an individual makes either voluntary or mandatory employee contributions to a plan, such individual shall be an active participant for the individual's taxable year containing the end of the plan year in which the contributions are allocated.

A11: In the case of a plan year that begins in 1986 and ends in 1987, will actions attributable to the 1986 part of the plan year that would normally make an individual an active participant for a year, make an individual an active participant for the 1987 taxable year?

A: No. For purposes of determining whether an individual is an active participant for 1987, a plan year beginning in 1986 and ending in 1987 (an “overlap plan year”) is to be treated as two short plan years, the first ending on December 31, 1986 and the second beginning on January 1, 1987. In addition, any employee contributions or employer

contributions or forfeitures allocated during the 1987 portion of the overlap plan year shall be treated as allocated on December 31, 1986 to the extent such contributions are attributable (i) to compensation that would have been paid (but for a deferral election) or was actually paid before January 1, 1987 or (ii) to services performed before January 1, 1987.

For example, if a participant in a cash or deferred arrangement that is part of a plan with an overlap plan year elects to have no elective deferrals made out of compensation that would have been paid (but for the deferral election) in the 1987 portion of the overlap plan year, such participant will not be treated as an active participant for the 1987 taxable year merely because of the elective deferrals made out of compensation that would have been paid (but for the deferral election) before January 1, 1987. Similarly, if a participant in a defined contribution plan with an overlap plan year separates from service from the employer on December 31, 1986, such participant will not be treated as an active participant for the 1987 taxable year merely because an employer contribution that is based on the participant's compensation and service before January 1, 1987 is allocated to such participant's account as of the last day of the overlap plan year.

A12: Is an individual considered an active participant merely because such individual participates in a plan as an Armed Forces reservist if the individual has less than 90 days of active duty during the year, or participates in a plan described in section 219(g)(5)(A)(iii) of the Code, based on activities as a volunteer firefighter?

A: No. Such individual is not an active participant pursuant to section 219(g)(6) of the Code.

A13: If only a single dollar is allocated to an individual's account for a plan year (in a defined contribution plan), or an individual accrues a benefit of only one dollar for a plan year (in a defined benefit plan), is such an individual an active participant in such plan?

A: Yes.

A14: If an amount is allocated to an individual's plan account for a plan year in a defined contribution plan, or an individual accrues a benefit for a plan year in a defined benefit plan, but such individual has no vested interest in such account or accrual, is such an individual an active participant in such plan?

A: Yes. Active participant status is determined without regard to vesting.

Defined Benefit Plan Active Participation Questions

A15: In many defined benefit plans a participant's right to benefit accruals is conditioned upon the performance of a prescribed number of hours of service. If an individual does not complete the requisite hours of service needed in order to accrue a benefit in a plan year, is the individual an active participant for such year?

A: Yes. If the individual is not excluded under the eligibility provisions of the plan for the plan year ending with or within the individual's taxable year, the individual is an active participant.

A16: If an individual participates in a defined benefit plan in which benefit accurals are frozen for the entire plan year ending with or within the individual's taxable year, is such individual an active participant in such plan for the taxable year?

A: No. When a plan is frozen, i.e., when benefit accruals under a plan have ceased for all participants, an individual in such a plan is not an active participant. However, where a benefit may vary with future compensation, all accruals will not be considered to have ceased. For example, a “High 3” plan, in which future accurals have ceased but the actual benefit will depend upon future compensation, will not be considered as a plan in which accurals have ceased for all participants.

A17: If a calendar year defined benefit plan terminates on January 2, 1988, is an individual who is covered under the plan an active participant for such individual's 1988 taxable year?

A: Yes. If an individual is not excluded under the eligibility provisions of the plan for any portion of the plan year ending with or within the taxable year, the individual is an active participant. Accordingly, an individual covered by the plan shall be an active participant for the taxable year in which the plan year ends, whether or not the plan terminated.

A18: If a calendar year defined benefit plan terminates on November 30, 1987, but does not commence distributions until January 31, 1988, is an individual covered under the plan an active participant in either plan year?

A: As noted in question A17, the individual will be an active participant for the taxable year within which the plan terminates (1987) because such individual was not excluded under the eligibility provisions of the plan in the plan year which ended with or within the taxable year. In the 1988 plan year, a participant is excluded under the eligibility provisions for the plan year which ends with or within the participant's taxable year because the plan has terminated.

Defined Contribution Plan Active Participation Questions

A19: Is an individual an active participant merely because earnings are allocated to such individual's account?

A: No. An individual is not an active participant merely because earnings have been allocated to such individual's account.

A20: Certain defined contribution plans condition the right to an allocation on the performance of a specified number of hours (e.g., 1,000) or on the employment of the participant on a certain day. In such a plan, if an individual does not meet the condition for a particular plan year, is the individual an active participant with respect to the taxable year within which such plan year ends?

A: No. An individual is not an active participant in a defined contribution plan if, under the terms of the plan, the individual is not entitled to an allocation of contributions or forfeitures to the individual's account with respect to the plan year ending with or within the individual's taxable year.

A21: If an employer sponsoring a defined contribution plan is required to make a contribution to an individual's account but fails to do so (whether or not in violation of section 412(d) of the Code), is an individual for whom an allocation is required an active participant in the plan for the plan year ending in the individual's taxable year?

A: Yes. In the case of such a plan, if an allocation must be made to an individual's account with respect to a particular plan year, such individual shall be an active participant in the taxable year in which such plan year ends, regardless of whether the contribution is made.

A22: If a plan is requied to make a top heavy minimum allocation for the plan year, and must make an allocation to the account of an individual who would not otherwise be entitled to an allocation for the plan year, is the individual an active participant merely because a top heavy minimum allocation is made to such individual's account?

A: Yes. If a top heavy minimum is required to be allocated to an individual's account, the individual is an active participant for the taxable year in which ends the plan year with or within which the allocation is required to be made.

A23: If an individual elects to defer compensation under a section 401(k) cash or deferred arrangement (CODA), is such individual an active participant?

A: Yes An individual who elects to defer compensation pursuant to a plan described in section 401(k) shall be an active participant. The same rule applies to elective deferrals and salary reductions under sections 408(k), 501(c)(18), and 403(b).

A24: If an individual who is eligible to make elective deferrals under a CODA declines to make elective deferrals for a year, and no other contributions or forfeitures are allocated to such individual's account for the plan year ending with or within the individual's taxable year, is such individual an active participant for that year?

A: No. An individual shall not be an active participant merely due to eligibility to participate in a CODA.

A25: If an individual makes an elective deferral during a plan year, but later has the deferral distributed from the plan as an excess deferral, (pursuant to section 402(g)(2) of the Code, is such individual an active participant for the taxable year with or within which ends the plan year?

A: Yes. For purposes of determining active participant status, if an individual chooses to make an elective deferral to a plan, the individual is an active participant for the plan year as of which the deferral contribution is allocated, regardless of whether the contribution remains in the individual's account.

A26: A profit sharing plan has a July 1 to June 30 plan year. Under the terms of the plan, employer contributions, if any, are made at the sole discretion of the Board of Directors. As of June 30, 1987, no employee or employer contributions have been made and no amounts have been forfeited for the plan year ending June 30, 1987. Moreover, it is impossible to determine whether a contribution will be made for the plan year ending on June 30, 1987. On January 15, 1988, the employer makes a contribution for the plan year ending on June 30, 1987. On November 30, 1988, the employer makes a contribution for the plan year ending June 30, 1988.

On June 30, 1989 it is again impossible to determine whether a contribution will be made for the plan year ending on that date, and no contribution is made by December 31, 1989. Will a participant in the plan described above be an active participant only for the 1988 taxable year?

A: No. In such a situation, when contributions to a discretionary defined contribution plan for two plan years are made in one calendar year, solely for the purposes of determining active participant status, the contributions for the later plan year are deemed to be made in the next taxable year. In the fact pattern described above, the contribution made on November 30, 1988 is deemed to be made in taxable year 1989. Thus, the individual is an active participant in both the 1988 and 1989 taxable year.

B. ***Adjusted Gross Income***

An active participant with AGI below the “applicable dollar limitation” may make a deductible contribution to an IRA up to the limits of section 219(b)(1) or (c)(2)(A) of the Code, as applicable. The “applicable dollar limitation” for an individual's taxable year is $25,000 for single taxpayers, $40,000 for married taxpayers filing a joint tax return, and zero for married individuals who file separately. The AGI used for purposes of section 219(g)(3)(A) (IRA deductions for active participants) is calculated after taking into account social security benefits (section 86 of the Code) and losses or gains on passive investments (section 469 of the Code). IRA contributions are not deducted when determining the relevant AGI.

If an individual is an active participant with AGI less than $10,000 above the applicable dollar limitation, the individual may make a deductible contribution to an IRA equal to the lesser of (i) the adjusted dollar deduction limit, or (ii) 100% of compensation. Such adjusted dollar deduction limit is based upon the amount by which the AGI exceeds the applicable dollar limitation. This is calculated using the following formula:

$$\frac{\$10{,}000 - (\text{Excess AGI})}{\$10{,}000} \quad \begin{matrix}\text{Maximum} \\ \text{Permissible} \\ \text{Dollar Deduction}\end{matrix} = \begin{matrix}\text{Adjusted Dollar} \\ \text{Deduction} \\ \text{Limit}\end{matrix}$$

Excess AGI is the amount by which the individual's AGI exceeds the applicable dollar limitation.

The maximum permissible dollar deduction is the section 219(b)(1)(A) limit of $2,000, or the section 219(c)(2)(A)(i) limit of $2,250, in the case of a spousal IRA.

If the adjusted dollar deduction limit is not a multiple of 10, it is rounded up to the next highest $10 increment. If the amount so calculated is below $200, but above zero, the adjustable dollar deduction limit equals $200. The 100% of compensation limit is unaffected by these adjustments to the dollar limit.

An individual is never permitted to take a deduction in excess of such individual's compensation. Thus, if the individual's compensation is less than the adjusted dollar deduction limit, the adjusted dollar deduction limit is equal to 100% of compensation. (See example 4).

Example 1: An individual who is single and an active participant in a section 403(b) annuity contract arrangement for a taxable year has an AGI for the taxable year of $33,000 (this is determined after the 403(b) salary reduction). To calculate the individual's adjusted dollar deduction limit the following steps must be taken:

Applicable Dollar Limitation = $25,000 Excess AGI = ($33,000 - $25,000) = $8,000

Maximum Permissible Dollar Deduction = $2,000

$10,000 -
$8,000

$2,000 = $400 adjusted

$10,000 dollar deduction limit.

Example 2: An individual is not an active participant in a plan, but the individual's spouse is an active participant for the taxable year. They file a joint tax return for the taxable year and each has compensation in excess of $2,000. Their AGI is $46,555. The adjusted dollar deduction limit for each spouse is calculated as follows:

Applicable Dollar Limitation = $40,000 Excess AGI = ($46,555 - $40,000) = $6,555

Maximum Permissible Dollar Deduction for the individual = $2,000

Maximum Permissible Dollar Deduction for the individual's spouse $2,000

$10,000 -
$6,555

$2,000 = $689 rounded

$10,000 to $690.

Each spouse may establish an IRA and may make a deductible contribution of $690 for the taxable year. Neither spouse may make a deductible contribution in excess of that

amount; that is, if one spouse makes a deductible contribution of only $100, the other spouse's deductible contribution is still limited to $690.

Example 3: If either spouse, in example 2, had no compensation for the year, or elected to be treated as having no compensation, a spousal IRA could be established for that individual. To calculate the maximum amount of a spousal IRA contribution which may be contributed to an account, the individual must use a two step process. First, the adjusted dollar deduction limit for the couple is calculated (assume the combined AGI is the same as in Example 2):

Applicable Dollar Limitation = $40,000

Excess AGI = ($46,555 - $40,000) = $6,555

Maximum Permissible Dollar Deduction = $2,250

$10,000 -
$6,555

$2,250= $775, rounded

$10,000 to $780.

The adjusted dollar deductions limit for the couple is $780. Second, to determine the maximum portion of this amount that may be allocated to a single account, the method in example 2 is used. Thus, no more than $690 of the $780 adjusted dollar deduction limit may be contributed to either of the two IRAs.

Example 4: A married individual filing a separate tax return is an active participant for a taxable year. The individual's AGI and compensation are $1,500 for the taxable year. The adjusted dollar deduction limit is calculated as follows:

Applicable Dollar Limitation = $0

Excess AGI = $1,500

Maximum Permissible Dollar Deduction = $2,000

$10,000 -
$1,500

$2,000= $1,700

$10,000

The adjusted dollar deduction limit is $1,700. However, because the individual may not deduct an amount in excess of 100% of compensation, in this example, the individual may make a deductible contribution of only $1,500.

Deductibility Questions

B1: In determining the adjusted dollar deduction limit, is the calculation described above performed on each spouse's separate AGI or on the couple's aggregate AGI?

A: When computing the adjusted dollar deduction limit for each spouse filing a joint-tax return, the couple's aggregate AGI is used (See example 2 above.)

B2: How is the adjusted dollar deduction limit calculated when an individual's compensation for a taxable year is less than $2,000?

The adjusted dollar deduction limit is first calculated under section 219(b)(1)(A) or section 210(c)(2)(A)(1). The individual may then make a deductible contribution to an IRA to the extent of the lesser of the adjusted dollar deduction limit and the 100% of compensation limit of section 219(b)(1)(B) or section 219(c)(2)(A)(ii).

(See example 4 above).

II. *Nondeductible Contributions to IRAs*

Section 408(o) of the Code provides that a taxpayer may make a nondeductible IRA contribution provided that such amount does not exceed the amount described in section 219(b)(1) or (c)(2)(A) of the Code (as applicable) reduced by the IRA contributions which are deducted for the year. Thus, an individual may make nondeductible contributions to the extent of the excess of (1) the lesser of $2,000 ($2,250 in the case of a spousal IRA) or 100 percent of compensation, over (2) the amount of the IRA contribution which is deducted. An individual may make nondeductible contributions in lieu of deductible contributions. Earnings attributable to deductible or nondeductible IRA contributions will not be subject to income tax until distribution.

When a taxpayer makes a nondeductible IRA contribution, any nondeductible portion of the IRA contribution must be indicated on the tax return for the year in which the contribution is made and in each subsequent year until the amount is fully recovered (section 408(o)(2)(C) of the Code). A taxpayer who overstates the nondeductible designation on the tax form is subject to a $100 penalty per overstatement unless the overstatement is due to reasonable cause and the taxpayer demonstrates that steps have been taken to correct the overstatement (see section 6693(b) of the Code).

Nondeductible IRA Contribution Questions

C1: May nondeductible and deductible contributions be made to the same IRA?

A. Yes. Section 408(o) of the Code provides that an individual need not designate a contribution as deductible or nondeductible until the tax return is filed. Moreover, the indiviudal is not, under the Code, required to report the nondeductible status of the contribution to the bank or institution holding the IRA. Accordingly, both deductible and nondeductible contributions may be made to a single IRA.

C2: What is the rule for removing excess contributions?

A: Prior to the Act, section 408(d)(4) of the Code permitted individuals who had made excess contributions to an IRA to withdraw such excess IRA contributions with earnings by April 15 of the year following the year for which the contribution was made. By withdrawing the excess in such manner, the individual was able to avoid the excess tax under section 4973 of the Code applicable to excess IRA contributions. Under the Act, amounts contributed to an IRA for an individual's taxable year (both deductible and nondeductible contributions) may be treated as excess contributions and withdrawn by the individual by April 15 of the following year. Generally, if an individual is not yet 591/2 at the time of the withdrawal, upon withdrawing such amounts the individual will be required to pay the early withdrawal tax under section 72(t) on the earnings (if any) for the year for which the contribution was made.

C3: May a taxpayer change a deductible or nondeductible designation of a contribution to an IRA on a prior year's return?

A: Yes. The designation may be changed by amending the tax return prior to expiration of the statute of limitations on assessments, pursuant to section 6501 of the Code. Of course, since contributions must be made by April 15 of the year following the year for which the contribution are made, no additional contributions may be made after that date.

C4: May an individual roll over employee contributions from a qualified plan to an IRA?

A: No. Section 402(a)(5)(B) continues to prohibit such a rollover.

III. *Distributions*

In general, the rules of section 72, including section 72(e)(8), will apply to the taxability of distributions from IRAs. To the extent that the following rules are inconsistent with the rules set forth in section 72, the rules in this Notice govern. For example, if an individual has a single IRA annuity contract the rules herein, which generally treat such a distribution as being an amount not received as an annuity under section 72(e), shall apply rather than those set forth in section 72 for annuities.

An individual who has made nondeductible contributions has, with respect to the IRA, investment in the contract (i.e., basis). In such a case a portion of the distribution will be treated as a nontaxable return of the nondeductible contributions (return of basis). The portion of the distribution attributable to the return of nondeductible contributions is determined by using the following formula:

Total Nondeductible
Contributions

Distribution
Amount

Total IRA Account Balance +
Distribution Amount +
Outstanding Rollover

An "outstanding rollover" is any amount distributed by an IRA within 60 days of the end of the taxable year, not rolled over to another IRA by the end of the year, but rolled over in the following year to another IRA before the 60 days end.

When making these computations the individual shall treat all IRAs, whether accounts or annuity contracts, maintained by the individual as a single IRA. This includes amounts held in Simplified Employee Pension (SEP) IRAs and rollover IRAs. In general, the total IRA account balance is the fair market value of all IRAs, computed as of the last day of the taxable year in which a distribution was made. The fair market value includes both realized and unrealized appreciation. The distribution amount is the sum of all distributions from the IRA during the taxable year. Each distribution is valued as of the day of distribution. Neither the numerator nor the denominator of the above equation shall include amounts previously withdrawn pursuant to section 408(d)(4) of the Code.

Example: An individual makes the following contributions:

	Deductible	*Nondeductible*
1984.....................................	$2,000	$0
1985.....................................	2,000	0
1986.....................................	2,000	0

1987.....................................	1,000	1,000
1988.....................................	1,000	1,000
1989.....................................	0	2,000
1990.....................................	0	2,000
	$8,000	$6,000

On October 31, 1992, the individual receives a distribution of $5,000. At the end of the year, the total IRA account balance is $12,500. There are no outstanding rollovers. The portion of the distribution which is not includable in gross income for 1992 is calculated as follows:

$$\frac{\$6,000}{\$12,500 + \$5,000} \times \$5,000 = \$1,714.30$$

$1,714.30 of the $5,000 distribution consists of a return of basis. The remainder is includible in the individual's income.

On June 30, 1993, the individual receives a distribution of $3,000. No additional contributions are made in 1993; and the total IRA account balance on December 31, 1993 is $10,875. There are no outstanding rollovers. The total nondeductible contributions made to any IRA must be reduced by the portion of prior distributions attributable to return of nondeductible contributions, in this case $1,714.30. Thus, the reduced nondeductible contribution balance equals $6,000 minus $1,714.30, or $4,285.70. The portion of the distribution which is not includible in gross income for 1993 is calculated as follows:

$$\frac{\$4,285.70}{\$10,875 + \$3,000} \times \$3,000 = \$926.64$$

$926.64 of the $3,000 distribution consists of return of basis. The remainder is includible in the individual's income.

The calculation to determine the nontaxable portion must be made each year in which a distribution is received.

See D7 below for an example involving outstanding rollovers.

Distribution Questions

D1: How is the return of basis in a distribution calculated if an individual has a number of accounts and annuity contracts but only wishes to take a distribution out of one account?

A: Section 408(d)(2) provides that, for purposes of calculating the tax on IRA distributions during a calendar year, all IRA accounts and contracts (including SEPs and rollover IRAs) are treated as a single IRA, taken at fair market value at the end of the calendar year in which the distributions are made (with the amount of the distribution added back in, other than distributions rolled over to another IRA within the year). For purposes of this section it does not matter whether the individual receives distributions from one account or several accounts.

D2: May an individual designate a particular distribution as being from such individual's nondeductible contributions?

A: No. Generally, under the new rules, each withdrawal is treated as a pro rata recovery of both the nontaxable portion (basis) and the taxable portion. This is true regardless of whether the nondeductible contributions are kept in a separate account with withdrawals only made from that separate account.

D3: Upon an IRA withdrawal, may an individual who has made nondeductible contributions to an IRA segregate the basis from the taxable portion of the withdrawal (using the formula above) and avoid taking any amount into income by rolling over the portion which would otherwise have been taxable?

A: No In such a case the amount withdrawn less the amount rolled over is the amount actually distributed. This amount would be used in the pro rata calculation to determine what portion is recovery of basis, and what part is included in gross income.

D4: May amounts attributable to nondeductible contributions be rolled over from one IRA to another?

A: Yes. Indeed, in rolling over amounts from one IRA to another, an individual must roll over amounts attributable to nondeductible contributions as well as deductible contributions.

D6: In what circumstances does an individual recognize a loss from an IRA?

A: A loss from an IRA may be recognized only when all amounts have been distributed and the amounts distributed are less than the individual's unrecovered basis. For example:

An individual makes contributions totaling $10,000, all nondeductible, to an IRA. The IRA earns $4,000 over the course of the 5 years. Distributions commence at the end of the fifth year and the individual removes $6,000. The nontaxable portion (return of basis) equals

$$\frac{\$10,000}{\$14,000} \quad \$6,000 = \$4,285.71$$

The remaining balance is $14,000 - $6,000 = $8,000

The remaining basis is $10,000 - $4,285.71 = $5,714.29

In the next year the IRA sustains a loss of $5,000. The account balance as of the end of the year is $3,000, which is less than the remaining basis. If the individual withdraws the entire $3,000, no pro rata calculation is necessary and the individual may claim a loss of $2,714.29. If the taxpayer withdraws less than the entire balance, the pro rata calculation is necessary.

D7: How is the taxability of a distribution determined when an individual has rolled over funds from one IRA to another?

A: Any amount distributed and rolled over during the taxable year (i.e., completed before December 31) will be present in an IRA account as of the close of the year and will be reported as part of the aggregate IRA account balance. However, if an amount is distributed from an account within the last 60 days of the taxable year and is not rolled into another account by December 31, but is later rolled over after December 31 and before the 60th day after the distribution, it is an “outstanding rollover” and is added to the denominator of the equation used to determine the portion of the distribution attributable to basis. If it is not rolled over in a timely manner, the distribution is not treated as an “outstanding rollover.” For example:

An individual has two IRAs and has made a total of $6,000 of nondeductible IRA contributions.

The individual takes a $300 distribution from IRA B on October 10, 1989. On December 11, 1989, the individual receives $7,000 from IRA A. There has not been any earlier distributions from either IRA. As of December 31, 1989, the individual has not yet rolled any amount into another IRA and thus, the year-end valuation does not include the distribution. On January 30, 1990, the individual rolls over $7,000 to another IRA. The year-end valuations of the accounts show the following:

IRA A	IRA B
	= $23,000
$3,000	$20,000

The amount removed from IRA A and rolled over on January 30, is, of course, not included in the valuation as of December 31, 1989; nor is the $300 distributed from IRA B and not rolled over later. To calculate the taxability of the 1989 distribution that was not rolled over (the $300), the "outstanding rollover" (the $7,000) must be added back to the denominator of the fraction used to determine the portion of the distribution attributable to basis. The portion of the distribution attributable to basis is thus calculated as follows:

$6,000

$300 = $59.41

($23,000 + $7,000) + $300
(IRA Account Balance + Outstanding Rollover) (Distribution)

D8: In calculating the IRA account balance for purposes of determining the pro rata distribution, are accounts owned by an individual's spouse included?

A: No. IRAs belonging to another person are not aggregated for purposes of this calculation.

D9: Is there any way to make an early distribution of IRA funds before age 591/2 without incurring the additional tax under section 72(t)?

A: Yes. Under Code section 72(t)(2)(A)(iv), distributions before age 591/2 are not subject to the additional tax if they are in the form of substantially equal periodic payments over the life or life expectancy of the individual, or of the individual and his or her beneficiary. In addition, under sections 72(t)(2)(A)(ii) and (iii), exceptions are provided for distributions attributable to the taxpayer's becoming disabled within the meaning of section 72(m)(7), and distributions made to a beneficiary after the death of the individual.

D10: If an individual receives a distribution, prior to age 591/2 , from an IRA to which nondeductible contributions have been made is the entire distributed subject to the additional tax under section 72(t) of the Code?

A: No, the tax is assessed only against the portion of the distribution which is includible in gross income.

D11: Are IRA trustees required to calculate the amount of the distribution attributable to return of basis for an individual?

A: No. Generally, the trustee will not have the information needed to make this calculation. The bank or institution holding the IRA must provide the actual account balance of each IRA, but is not required to know whether a particular contribution was deductible or nondeductible and is not required to have a record of the aggregate nondeductible contributions. Accordingly, the taxpayer is responsible for calculating the taxable amount of an IRA distribution.

IV. *Spousal IRAs*

Under section 219(c)(1)(B) of the Code, as amended, a married couple filing a joint tax return may elect to treat one spouse as having no compensation for purposes of establishing a spousal IRA. This provision is effective for contributions made before, on or after the taxable years beginning after December 31, 1985.

E1: May a married couple make a contribution to a spousal IRA with respect to a spouse who made $100 of compensation during the 1986 taxable year?

A: If the couple elects on their joint tax return to treat that spouse as having no compensation for the year, they may establish a spousal IRA.

E2: May a taxpayer amend his or her tax returns for the 1985 and prior taxable years and contribute to spousal IRAs for those years?

A: No. Section 219(f)(3) and the regulations thereunder provide that contributions to an IRA must have been made no later than the time prescribed by law for filing the return for such taxable year (excluding extensions).

V. *Collectibles*

The Act creates an exception to the general rule set forth in section 408(m)(1) under which acquisition of collectibles (as defined in section 408(m)(2)) are treated as distributions. To the extent that IRA funds are invested after December 31, 1986, in gold or silver coins issued by the United States, as specified in 31 USC 5112(a)(7), (8), (9), or (10), or 31 USC 5112(a), such funds will not be treated as distributed. IRA funds attributable to contributions made before December 31, 1986, may also be invested in such coins.

An investment by an IRA in a coin which has been made into jewelry is still considered an investment in a collectible, and will be treated as a distribution.

VI. *Withholding*

Under section 3405(b)(1)(B) of the Code, for purposes of withholding taxes, the payor must assume that the entire amount of an IRA distribution is taxable.

VII. *Deductible Employee Contributions*

For taxable years beginning after January 1, 1982, a qualified retirement plan may allow participants to make deductible contributions to separate accounts within the plan. The Act prohibits these qualified voluntary employee contributions (QVECs) for years beginning after December 31, 1986. Plan administrators may not accept such contributions in any calendar year after 1986 (except those made before the April 15, 1987 filing date specifically for the 1986 year). Plans need not be amended for this change until the amendment date for other retirement plan changes required by the Act (generally, the first plan year beginning on or after January 1, 1989).

Plans with QVECs need not immediately distribute the amount already accumulated in such accounts. In addition, amounts now held in such accounts are not aggregated with IRA accounts for purposes of determining the nontaxable portion of an IRA distribution.

VIII. *IRA Arrangements*

Trustees using model IRAs Master IRAs or Prototype IRAs are not required to amend their IRA documents to comply with the new law until notified to do so by the Service. The Act generally affects individual deductions rather than provisions required to be in most IRA documents.