STIFEL

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PATH ACT MAKES PROVISIONS FOR IRA/RETIREMENT PLANS PERMANENT

On December 18, 2015, President Obama signed into law H.R. 2029 (Protecting Americans from Tax Hikes Act of 2015 (PATH Act)), which is combined tax extender and federal budget legislation.

Qualified Charitable Donations (QCDs)

One provision that is included in the Act is a popular option for IRA owners age 70½ or older to make tax-free withdrawals, up to a maximum of $100,000 each year, payable to a qualified charity. This option, which was originated in The Pension Protection Act of 2006, was extended several times over the years but was due to expire December 31, 2014. However, the PATH Act extended the provision through December 31, 2015 and made it permanently available for 2016 and beyond.

In addition to owners of IRAs, it's important to note that the QCD option is also available to inherited IRA beneficiaries who have reached age 70½ or older. Conversely, this option is not available for assets in active SEP or SIMPLE IRAs.

Rollovers to SIMPLE IRAs

Another provision included in the Act will allow owners of traditional, SEP and SIMPLE IRAs (not Roth IRAs), and participants in qualified retirement plans (QRPs), 403(b) and governmental 457(b) plans to rollover assets into SIMPLE IRAs after the SIMPLE IRAs two-year rule has been satisfied. This option, which can assist individuals who are looking to consolidate multiple retirement accounts, became effective upon enactment of the Act.

Briefly, other IRA or QRP highlights of the Act include:

- Tuition program (529 plan) and Coverdell Education Savings Account (ESAs): Changes were made to the definition of higher education expenses to include costs for the purchase of computers and related equipment, software, and Internet access for qualified distributions. Note that these expenses will qualify if the equipment and services are primarily used by students during any of the years they are in school. This is effective for distributions made after December 31, 2014. (Such computer expenses already were qualified elementary and secondary expenses for ESA distributions.)
- Airline bankruptcy settlement payments eligible for rollover to IRAs will now include settlements occurring within the 180-day period beginning on the date of enactment (December 18, 2015).
- The definition of "qualified public safety employee" for purposes of the age-50 exemption from the 10% additional tax on early distributions from governmental retirement plans has been expanded to include nuclear materials couriers, U.S. Capitol police, Supreme Court police, and diplomatic security special agents. This is effective for distributions after December 31, 2015.

A complete summary of the Act can be reviewed at this web site: http://waysandmeans.house.gov/wp-content/uploads/2015/12/SECTION-BY-SECTION-SUMMARY-OF-THE-PROPOSED-PATH-ACT.pdf

SEP IRAs STILL AVAILABLE FOR 2015

For business owners whose tax year is based upon the calendar year, December 31, 2015 was the last day a Qualified Retirement Plan (QRP) could be established for 2015. However, employers have until the due date of their federal income tax return for the business, including extensions, to establish a SEP and make contributions to the SEP for 2015.

Contributions

The maximum amount that can be contributed for 2015 on behalf of each SEP participant is the lesser of:

- 25% of compensation (IRC Sec. 402(h) limit) up to the compensation cap of $265,000 or
- $53,000 per individual (IRC Sec. 415(c) dollar limitation)

Contributions for the self-employed

For the self-employed, a special formula must be used to calculate the maximum deductible contribution. When figuring the deductible contribution, "compensation" is the "net earnings," which takes into account both of the following deductions:

1. The deductible portion of an individual's self-employment tax
2. The contributions to the SEP IRA.

To accomplish this calculation, a self-employed individual must reference Chapter 5 of IRS Publication 560 - Retirement Plans for Small business (website: http://www.irs.gov/publications/p560/) and apply the Rate Table for Self-Employed or the Rate Worksheet for Self-Employed, whichever is appropriate. After referencing the correct table, the business owner must figure the maximum deductible contribution by using the Deduction Worksheet for Self-Employed located in the same chapter. Note that this computation can be confusing, and it's strongly recommended that a self-employed individual seek the aid of a professional tax consultant before making final decisions.

Benefits

There are several distinct benefits associated with SEPs, such as:

1. They may be established and funded by the business owner's tax filing deadline (plus extensions)
2. Contributions are deposited directly into eligible participants' SEP IRA accounts
3. No IRS Form 5500 reports are required
4. Little administration results in low fees
5. Discretionary contributions – contributions to a SEP are not mandatory for any particular year and an employer may change the percentage of contribution or skip it entirely for any year
6. No fiduciary responsibility for the owner

Closing comment

A SEP is a very attractive plan for small business owners and is the only plan that can be established in 2016 to take advantage of a 2015 tax deduction.

IRA DISTRIBUTIONS FOR QUALIFIED CHARITABLE DONATIONS – MADE PERMANENT

Certain IRA holders have the opportunity to donate assets in their IRA to qualified charitable organizations. If it's done correctly, the distributions are tax-free and not included as ordinary income. The provision applies for traditional and Roth IRAs and does not typically apply to distributions from active SEP or SIMPLE IRAs unless an employer contribution was not made to the SEP or SIMPLE IRA during or for the year the charitable distributions are made.

Previously, this benefit was available only through December 31, 2014. However, on December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes (PATH) Act of 2015, which includes a provision to make qualified charitable donation (QCD) benefit permanent.

Eligibility and donation limit

To be eligible for QCDs, IRA holders must be at least 70½ years of age on or before the actual day of the donation. In addition, to qualify as a QCD, the IRA custodian/trustee must make the distribution directly to the qualified charity. Any distributions, including RMDs, in which the IRA owner takes constructive receipt cannot qualify as a QCD.

For those who do qualify by age, their maximum QCD is limited to $100,000 per tax year. Any distributions in excess of this limit will not qualify for the tax exclusion benefit and will be treated as ordinary income. Note that distributions of base contributions and tax-paid conversions to Roth IRA holders are generally not considered taxable income.

Benefit of excluding income

By not including a QCD from an IRA as ordinary income, an individual's adjusted gross income is not increased, which could affect the ability to qualify for Roth contributions or have other tax ramifications.

Qualified charities

For information pertaining to qualified charities, go to the IRS web site –www.irs.gov/individuals– and select the "Help & Resources" tab, then click on the "Charities and Non-Profits" link on the left, and review the "Search for Charities" section.

RECOGNIZING LOSSES ON IRA INVESTMENTS

Under certain conditions individuals may be eligible to recognize the loss on a traditional or Roth IRA investment when filing their income tax return.

Conditions for a tax loss

In order for a tax-filer to claim a loss in a traditional IRA, the following conditions must be met:

1. All amounts in all traditional IRAs (not Roth IRAs) owned by that individual must be distributed.
2. The total traditional IRA distributions must be less than the individual's unrecovered basis, if any.

The same holds true for Roth IRAs; traditional IRA assets are not considered when meeting these requirements, but all Roth accounts for an individual must be distributed.

Determining basis

"Basis" is defined as the total amount of non-deductible contri¬butions in the individual's traditional IRAs that were reported on IRS Form 8606 (Non-deductible IRAs and Coverdell ESAs). "Unrecovered basis" is created when assets are distributed and the value of the investments distributed is lower than the amount of all non-deductible contributions (the basis). Note that distributions may be taken "in-kind."

For example, an individual has a traditional IRA and previously reported $5,000 as a non-deductible contribution (the basis). In 2016, the value of the IRA is now $4,000 and the individual takes a complete distribution. The individual has a net unrecovered basis of $1,000 ($5,000 - $4,000) and can claim the loss as a miscellaneous itemized tax deduction. Note, however, a tax-filer's miscellaneous expenses must exceed a minimum of 2% of AGI. For instance, if an individual has AGI of $50,000, a miscellaneous tax deduction would be allowed for amounts exceeding $1,000 (2% of $50,000). For the above example, if no other miscellaneous itemized expenses are reported, the amount does not exceed the minimum and, therefore, a deduction is not available.

Given the recent drop in value of most investments, many IRA holders may be able to take advantage of the loss at this time with the prospect of improved security value at a future date.

For additional information, reference IRS Pub. 590-B Individual Retirement Arrangements (IRAs) at www.irs.gov.

IRS OFFERS FINANCIAL INCENTIVES TO CORRECT PLAN ISSUES

The Internal Revenue Service (IRS) is offering financial incentives to encourage plan sponsors to correct certain plan failures. Employers that sponsor 403(b) or 401(a) qualified retirement plans may be eligible for reduced fees. 401(a) plans are retirement plans that fall under IRS Code Section 401(a) and include Money Purchase Plans, Defined Benefit Plans, Profit Sharing Plans, and 401(k) Plans.

Corrections to these plans may be made through the Voluntary Correction Program (VCP). The VCP enables a plan sponsor, at any time prior to an IRS audit, to voluntarily disclose to the IRS any qualification failures it has discovered in its own plan, pay a fee that is generally less than if the IRS were to discover the failure, and receive IRS approval for the correction. Plan failures include plan document failures where a plan provision violates IRS sections 401(a) or 403(b), operational failures where a plan does not follow the provisions of the plan document, demographic failures where the plan does not satisfy the nondiscrimination, participation, or coverage requirements or employer eligibility failures where a 401(a) or 403(b) plan was established or adopted by an employer who was not eligible to do so.

VCP fees have been reduced for submissions made on or after Feb. 1, 2016. The fees are based on the number of participants in the plan and in most cases have changed dramatically. The new general VCP fees are as follows:

- 20 or fewer participants: $500
- 21-50 participants: $750
- 51-100 participants: $1,500
- 101-1,000 participants: $5,000
- 1,001-10,000 participants: $10,000
- More than 10,000 participants: $15,000

The form used to guide plan sponsors through the correction process, Form 8951 Compliance Fee for Application for Voluntary Correction Program (VCP), is currently being revised. However, the IRS states that Form 8951 can be used for corrections but plan sponsors should ignore the fee amounts listed on the Form as they have not been updated yet and will likely result in the plan sponsor overpaying. Sponsors should attach a check for the fee amount specified in Rev. Proc. 2016-8, Section 6.08 (or Rev. Rev. Proc. 2013-12, section 12, if applicable and as modified by Rev. Proc. 2015-27).

Any VCP submissions made prior to February 1, 2016 will not benefit from the discounted fee amounts and must pay according to the prior fee schedule. To pay the reduced fee amount, the VCP must be done on February 1, 2016 or later. Also note that the IRS will not issue refunds for VCP submissions made prior to February 1, 2016.

For more information, see IRS ruling: https://www.irs.gov/irb/2016-01_IRB/ar14.html

DEFINED BENEFIT PLANS OFFER THE LARGEST TAX DEDUCTIONS

Highly successful, age 40+ business owners with a profit sharing, SEP, or 401(k) plan may be able to make substantially larger tax-deductible contributions via a defined benefit (DB) plan.

In addition to a household's primary income source, a spouse with substantial self employment income which is not needed today can maximize savings on a tax-favored basis with a DB plan. Also, substantial sole proprietor income from moonlighting can be the basis of a DB contribution.

DBs work exactly as their name indicates; the benefit is defined. Business owners can fund for a maximum benefit of up to the lesser of 100% of their income or $210,000 per year (2016) at age 65. An actuary calculates how much must be contributed each year to fund for the future benefit. There is no limit to the amount that may be contributed as long as it is actuarially necessary to fund for the benefit. Hence, DBs offer the largest tax deductions of any qualified plan.

Whereas DB contributions are generally sizeable and required every year, the actuary can provide a range of contribution amounts to help business owners tailor their contributions to best suit their annual circumstances.

Save Fast

Baby boomer business owners who are just now beginning to focus on retirement can, if their income supports it, save more than $2.6 million on a tax-deferred basis in just ten years via a DB plan.

The chart below compares the DB's contributions per owner to the $53,000 (2016) or $59,000 (includes catch-up, 2016) maximum they could receive in a defined contribution (DC) plan, such as a profit sharing plan. Based on a 45% tax rate, the four employers can enjoy a combined tax deduction of $224,100 ($498,000 x .45) in a DB plan vs. only $100,800 ($224,000 x.45) in a DC plan.

DB Plan v DC Plan

	Age	Compensation	DC	DB
Owner 1	60	$265,000	$59,000	$228,000
Owner 2	50	$265,000	$59,000	$133,000
Owner 3	40	$265,000	$53,000	$78,000
Owner 4	35	$265,000	$53,000	$59,000
Total		$1,060,000	**$224,000**	**$498,000**

Maximizing Tax Deductions

A DC plan can be added to the DB, enabling the owners to further increase their deductions!

The first step is determining whether the DB plan is required to be covered by the Pension Benefit Guarantee Corporation (PBGC), as this will establish the potential maximum tax deduction. The PBGC, a wholly owned government corporation, insures most DB plans to guarantee that benefits can be paid to participants even if the sponsoring employer goes bankrupt. Certain DB plans, including those of professional service employers (PSE) with 25 or fewer active participants, are exempt from the PBGC. Examples of a PSE include medical, legal, engineering, or accounting firms.

Plans not covered by the PBGC

For DB plans NOT covered by the PBGC, a 401(k) plan can be established in addition to a DB plan allowing plan participants to defer up to the maximum of $18,000 (2016) or $24,000 (includes catch-up, 2016) plus receive a profit sharing (PS) contribution of up to 6% of compensation. See example below.

	Age	Compensation	DB Compensation	Deferral	Catch-up	PS Contribution	Total Contribution
Owner 1	60	$265,000	$228,000	$18,000	$6,000	$15,900	$267,900
Owner 2	50	$265,000	$133,000	$18,000	$6,000	$15,900	$172,900
Owner 3	40	$265,000	$78,000	$18,000		$15,900	$111,900
Owner 4	35	$265,000	$59,000	$18,000		$15,900	$92,900
Total			$498,000	$84,000		$63,600	**$645,600**

Plans covered by the PBGC

For DB plans covered by the PBGC, a 401(k) plan can be added to a DB allowing plan participants to defer up to the maximum of $18,000 or $24,000, plus receive a full PS contribution of up to 25% of compensation, as long as the total DC allocation does not exceed $53,000 (2016) or $59,000 (includes catch-up, 2016). See example below.

	Age	Compensation	DB Compensation	Deferral	Catch-up	PS Contribution	Total Contribution
Owner 1	60	$265,000	$228,000	$18,000	$6,000	$35,000	$287,000
Owner 2	50	$265,000	$133,000	$18,000	$6,000	$35,000	$192,000
Owner 3	40	$265,000	$78,000	$18,000		$35,000	$131,000
Owner 4	35	$265,000	$59,000	$18,000		$35,000	$112,000
Total			$498,000	$84,000		$140,000	**$722,000**

Creditor Protection

DB plans (as with other qualified plans) that cover at least one employee, other than the business owner(s), partners, and their spouses, can offer retirement savings that are guaranteed under ERISA to be secure from creditors.

Cash Balance Defined Benefit Plans

For some business owners, a cash balance type of DB plan may be preferable since it can provide the same tax deductions and savings as a traditional DB plan but the plan benefits can be more easily understood and appreciated by the employees. In a cash balance plan, an employee's current retirement benefit is shown as an account balance whereas a traditional DB plan offers an "accrued benefit," for example, $1,000 per month at age 65.

Defined Benefit Plan Administration

Your Financial Advisor, working with Stifel's Retirement Plan Services Department, can help identify a suitable third-party administrator (TPA) and actuary who, after getting your information, can create illustrations to help determine if a DB plan is right for you and your business. If desired, the TPA can also provide documents to establish and maintain your DB plan.

A DB plan can maximize tax deductions and help business owners to achieve their retirement goals.

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