STIFEL

Retirement Plans Quarterly

First Quarter 2017

TRADITIONAL AND ROTH IRA CONTRIBUTIONS FOR 2016

Even though 2016 has come to an end, contributions for 2016 may still be deposited into IRAs. This year's deadline is April 18, 2017, because the normal filing deadline of April 15 falls on Saturday and April 17 is Emancipation Day. For 2016 and 2017, the maximum contribution is limited to the lesser of an individual's earned income or $5,500. In addition, tax filers age 50 (reached by December 31, 2016) or older may contribute an additional "catch-up" contribution of $1,000.

Traditional IRA Deduction Eligibility

Traditional IRAs have the advantage of tax deductions and tax-deferred growth. And, contributions may be made until the year a tax filer reaches age 70½. However, contribution deductibility depends on whether an individual is an active participant in an employer-sponsored plan. If an individual actively participates in an employer's qualified retirement plan (including SEP and SIMPLE IRAs), then his/her Adjusted Gross Income (AGI) (IRS Form 1040, line 37) will determine whether IRA contributions are eligible for a tax deduction for 2016. A single tax filer's AGI must be below $61,000 to be eligible for a full deductible contribution, and a joint filer's AGI must be below $98,000 for the full deductible contribution. Partial deductible contributions can be made if AGI is between $61,000 and $71,000 for single filers and between $98,000 and $118,000 for joint filers. No deduction can be taken if AGI is more than these levels.

Worksheets to determine partial deductibility may be found on pages 35 and 36 in the IRS Form 1040 Instructions booklet. However, let's take a look at hypothetical examples using a simple formula to determine partial deductions when a tax filer's AGI falls between the eligibility limits for a deduction.

Individual Filer (maximum AGI limit $71,000)

Formula: $$\frac{\$71{,}000 - \text{AGI}}{\$10{,}000} \times \text{Annual Contribution Limit} = \text{Partial Deductible Amount}$$

Example: Theresa, age 45 and participating in her employer's qualified retirement plan, has an AGI of $69,000. The maximum contribution that is eligible for deduction for 2016 is $1,100, and it is calculated as follows:

$71,000 – $69,000 = $2,000
$2,000 ÷ $10,000 = 0.20
0.20 X $5,500 = $1,100

Married, filing a joint return (maximum AGI limit $118,000)

Formula: $$\frac{\$118{,}000 - \text{AGI}}{\$20{,}000} \times \text{Annual Contribution Limit} = \text{Partial Deductible Amount}$$

Example: Bob and Mindy, both over age 50 and participating in their employers' qualified retirement plans, have a combined AGI of $106,000. Each may contribute a maximum deductible amount of $3,900 for 2016. It is calculated as follows:

$118,000 – $106,000 = $12,000
$12,000 ÷ $20,000 = 0.60
0.60 X $6,500 = $3,900

Note: If one spouse is an active participant in an employer's qualified retirement plan and the other spouse is not, the spouse that is not may make a fully deductible IRA contribution if the couple's AGI is less than $184,000. A partial deductible contribution may be made for a non-active spouse if the couple's AGI is between $184,000 and $194,000.

Married, filing a separate return *For married couples that file separately but have lived together for any time during the year, the deduction eligibility phases out from $0 – $10,000 AGI.*

Formula: $$\frac{\$10{,}000 - \text{AGI}}{\$10{,}000} \times \text{Annual Contribution Limit} = \text{Partial Deductible Amount}$$

Example: Michael is married, and he and his spouse live together and file separate tax returns. He is 48, participates in his employer's qualified retirement plan, and his 2016 AGI is $8,700. Michael's maximum contribution that is eligible for deduction is $715 and is calculated as follows:

$10,000 – $8,700 = $1,300
$1,300 ÷ $10,000 = 0.13
0.13 X $5,500 = $715

Roth IRA Contribution Limit
A feature that makes Roth IRAs so popular is the potential for tax-free distribution after five years has passed from the first contribution date, and the IRA owner has reached age 59½. The ability to take tax-free withdrawals passes to the IRA beneficiaries as well. However, eligibility to contribute the full amount of $5,500 (or $6,500 if age 50 or older) to a Roth IRA depends on an individual's (or married couple's) AGI for the year.

2016 Contribution Eligibility
In order to be eligible to make a full $5,500 Roth IRA contribution, a single filer's AGI must be under $117,000, or $184,000 for married couples filing jointly. A partial contribution may be made for single filers if AGI is between $117,000 and $132,000. For married couples, a partial contribution may be made if AGI is between $184,000 and $194,000.

Worksheets to determine contribution eligibility may be found on pages 41-43 in IRS Publication 590-A. However, let's take a look at hypothetical examples using a simple formula to determine partial contributions when a tax filer's AGI falls between the eligibility limits.

Single Individuals

$$\text{Formula: } \frac{\$132{,}000 - \text{AGI}}{\$15{,}000} \times \text{Annual Contribution Limit} = \text{Partial Deductible Amount}$$

Example: Joe, age 40, has AGI of $121,500. The maximum amount he may contribute for 2016 is $3,850, and it is calculated as follows:

$132,000 – $121,500 = $10,500
$10,500 ÷ $15,000 = 0.70
0.70 X $5,500 = $3,850

Married, filing a joint return

$$\text{Formula: } \frac{\$194{,}000 - \text{AGI}}{\$10{,}000} \times \text{Annual Contribution Limit} = \text{Partial Deductible Amount}$$

Example: Tom and Alice, both over the age of 50, have a combined AGI of $185,000. The maximum amount each individual may contribute for 2016 is $5,850, and it is calculated as follows:

$194,000 – $185,000 = $9,000
$9,000 ÷ $10,000 = 0.90
0.90 X $6,500 = $5,850

Married, filing separate returns *For married couples that file separately but have lived together for any time during the year, the contribution eligibility phases out from $0 – $10,000 AGI.*

$$\text{Formula: } \frac{\$10{,}000 - \text{AGI}}{\$10{,}000} \times \text{Annual Contribution Limit} = \text{Partial Deductible Amount}$$

Example: Mary is married, and she and her spouse live together and file separate tax returns. She is 35, and her 2016 AGI is $9,000. Mary's maximum contribution is $550, and it is calculated as follows:

$10,000 – $9,000 = $1,000
$1,000 ÷ $10,000 = 0.10
0.10 X $5,500 = $550

As shown in these hypothetical examples, there is little mystery involved when determining eligibility for deductible traditional IRA contributions and Roth IRA contributions. However, the responsibility of calculating the correct contribution amount falls on the IRA holder and help from a competent CPA or tax advisor should be sought before final decisions are made.

COVERDELL EDUCATION SAVINGS ACCOUNTS (ESAs)

An ESA is an IRA account funded solely for the purpose of paying qualified educational expenses incurred by the designated beneficiary of the account. The contribution limit for 2016 is $2,000 and remains unchanged for 2017. So, with the contribution limit set at $2,000, why are ESAs popular? In ESAs, qualified education expenses include not only higher educational expenses, but also K-12 expenses. In addition, distributions made to pay qualified educational expenses are tax-free.

Eligibility
Contributions may be made to ESAs by individuals whose AGI does not exceed these levels:

Individual Returns (AGI)
$95,000 – $110,000
Joint Returns (AGI)
190,000 – $220,000

A partial contribution may be made if AGI falls between these ranges.

Contributions

- Other than rollovers, must be made in the form of money, not in-kind securities
- Are non-deductible
- Must be made before the beneficiary reaches age 18
- Cannot exceed $2,000 per beneficiary per year

- Must be made by April 15 of following year (April 18, 2017, for 2016)
- Can be made by individuals, corporations, and tax-exempt organizations
- Do not require a contributor to have earned income
- May not be made from an UGMA or UTMA

Distributions
Distributions are free from income tax if they do not exceed the beneficiary's adjusted qualified education expenses for the year. A taxpayer is allowed to claim Hope and Lifetime Learning Credits for the same year an ESA distribution is made. However, the taxpayer cannot use the ESA distribution to cover the same educational expenses claimed for the Hope and Lifetime Learning Credits. A distribution may be subject to taxes and a 10% penalty if not used for a qualified expense. If the ESA is not used for higher education, it must be distributed 30 days after the earlier of the beneficiary reaching age 30 (unless he/she has special needs) or his/her date of death.

Qualified Education Expenses
An ESA may be utilized for the following qualified education expenses for grades K-12: tuition and fees, books, supplies, equipment, basic room and board (must be at least half-time student), tutoring, computer equipment, uniforms, and special needs services.

An ESA may be utilized for the following qualified education expenses for higher education: tuition and fees, books, supplies, equipment, and basic room and board (must be at least half-time student).

Distributions may also be taken from ESAs and rolled into a 529 Plan on behalf of the designated beneficiary.

Rollovers
An ESA may roll over into another ESA for the same beneficiary. The beneficiary may be changed to another family member (child or stepchild, sibling, first cousin, in-law, or parent) under the age of 30. Also, an indirect (60-day) rollover may be completed with an ESA one time during every rolling 365 days.

In conclusion, ESAs remain a viable tool for educational expenses, along with custodial accounts and 529 plans.

HOW DO CONTROLLED GROUPS AFFECT RETIREMENT PLANS

A controlled group exists when one or more corporations must be treated as one employer for purposes of a qualified retirement plan. There are two basic types of controlled groups. A parent-subsidiary controlled group exists when one corporation owns at least 80% of the stock of another corporation. The second type is a brother-sister controlled group. This group is defined as two or more corporations in which five or fewer owners, directly or indirectly, own a controlling interest of each group and have effective control.

A controlled group status directly affects the testing requirements for a qualified retirement plan. When one of the two controlled groups defined above exists for a business, the number of employees for all of the locations/corporations must be aggregated together to satisfy coverage testing regardless if there are separate retirement plans available to each group. As a reminder, coverage testing calculates the number of employees benefitting from the availability of a retirement plan versus the employees that are actually participating in the plan. Varying demographics and plan participation levels can have a huge impact on the coverage testing results.

Identifying a controlled group is especially important in the case of a merger or acquisition and can sometimes have the potential to become costly to an employer if the implications of failing coverage testing are not considered. If a potential controlled group situation arises due to a recent or upcoming merger/acquisition transaction, enlist the assistance of a third-party administrator to examine the potential issues and opportunities that may arise as a result.

IRS UPDATES:

Orphaned Individual Plans
The Internal Revenue Service (IRS) clarified the steps necessary for one-participant plan sponsors to prevent their qualified retirement plans from becoming "orphan plans." Orphan retirement plans are plans that no longer have a plan sponsor. If a plan is no longer sponsored by an employer, it ceases to be a qualified plan and loses its tax-favored status.

Common reasons that plans become orphaned include: the plan sponsor dies without having first named a successor, the plan sponsor retires, or the plan sponsor abandons the plan before properly terminating the plan.

One-participant plan sponsors are one-person companies (without any employees) and may have an individual 401(k) plan or a solo defined benefit plan. Because these plan sponsors do not have any employees, they might not feel a sense of urgency to address their plan when they, for example, retire or sell their business.

The IRS has clarified that these types of plans must go through the normal termination process, albeit an abbreviated one since there are no additional employees to notify or distribution paperwork to be collected and processed from employees. However, the plan termination must still include, among other things, the updating of the plan document, the distribution of all assets, and the filing of the final Annual Return/Report of Employee Benefit Plans, which is more commonly known as the Form 5500. (Note: The final Form 5500 must be filed even if the plan never reached the $250,000 threshold required for filing annual 5500s.) The distribution of assets may involve a rollover into an IRA or another qualified plan, taking a taxable distribution, or a combination of the two.

The IRS further states that if a plan sponsor is unable to terminate the plan, it must designate someone else to do so. For plans that have already been orphaned, an eligible party may correct the issue using the IRS-sanctioned Voluntary Correction Program (VCP) or Audit Closing Agreement Program (Audit CAP). "Eligible party" refers to a court-appointed representative with authority to terminate the plan and dispose of the plan's assets, a person or entity the DOL determined has accepted responsibility for terminating the plan and distributing the plan's assets in the case of a plan under DOL investigation, or, in some

cases, a surviving spouse who is the sole beneficiary of a one-participant plan. For more information, see:

https://www.irs.gov/retirement-plans/plan-sponsor/fixing-common-plan-mistakes-using-epcrs-to-terminate-an-orphan-plan

Determination Letters

Another update from the IRS is the cutback on its "determination letter" program. A determination letter is a formal document that states that a retirement plan meets the Internal Revenue Code's qualification requirements. While not generally required, having a favorable determination letter from the IRS can give an employer assurance that its plan is qualified under Code Section 401(a) and that the plan's trust is exempt under Code Section 501(a).

As of January 1, 2017, the IRS will only issue determination letters for the Individually Designed Plans' initial qualifications and terminations. The Individually Designed Plan is a document that is drafted by an attorney for a specific employer and tailored to meet the employer's specific needs but only accounts for less than 20% of all qualified retirement plans. Most plan documents are Pre-Approved Plan documents (either prototype or volume submitter), which means that more than 80% of qualified plans will now be left out of the determination letter program. Additionally, the requirement for a plan sponsor to submit a determination letter application to the IRS when correcting qualification failures that include a plan amendment no longer applies.

Starting in 2018, the IRS will make a decision on whether it has the capability to extend the service to all other plans that request determination letters. The decision will be based on IRS staffing and workload levels. For more information, see: https://www.irs.gov/retirement-plans/new-determination-program-rev-proc-2016-37

COMMON TRIGGERS FOR PLAN AUDITS

The Department of Labor (DOL) and IRS, through a series of more frequent retirement plan audits, are taking a closer look into the operations of qualified retirement plans to examine how plan sponsors are administering their plan. If a retirement plan comes under audit by one of these two groups, be prepared for a lot of data requests that can extend to providing a full census file that includes transactions for each participant.

The number one violation that auditors have identified is the timely remittance of employee deferrals.[1] The regulations require that small plans with fewer than 100 participants must remit deferral contributions within seven business days of when the employees were paid. Larger plans should make every effort to remit contributions as soon as administratively feasible after each payroll. The IRS expects deferrals to be deposited within three to five days; however, the deposit deadline is 15 business days following the date in which employees were paid. Lost earnings and excise taxes on late deposits will be incurred after 15 business days.

The next most common mistake found in audits is the plan's definition of compensation.[2] Payroll can be extremely complex and comprised of many sources, such as base pay, bonus, overtime, commissions, and fringe benefits. In addition, there are multiple types of compensation that can be considered eligible for purposes of participant contributions. The plan document defines which compensation type is to be used for plan purposes, e.g., W-2, 415, 3401.

Of course, the ever-present DOL scrutiny on level fees and oversight of investment offerings in a retirement plan has been a focus of plan audits.[2] Plan sponsors should be documenting plan committee meetings in which the investments are reviewed and any investment not performing well should be added to a watch list to take action when needed. For plans with self-directed brokerage accounts, the DOL requires that trustees analyze and approve of investments and that participants receive adequate education and understand the risks associated with equity investments.

The administration of distributions from qualified retirement plans is another operational task that is reviewed during a plan audit.[1] The payment of benefits to vested terminated participants is closely examined, as many employers do not take measures to track participant addresses years after participants leave employment. As a result, reporting terminated participant balances has been made a requirement of the Form 5500 report. Proper administration of plan loans and hardship withdrawals are also problem areas. The DOL and IRS frequently uncover plans that are not charging the correct interest rate, permitting loans in excess of the statutory limits, or funds that are issued for purposes other than for reasons of financial necessity in the instance of a hardship.

Last, but certainly not least, the DOL expects the plan sponsor to substantiate that service providers are regularly monitored to ensure that fees being charged are reasonable.[2]

A periodic review of the plan's administrative policies and written plan document will help ensure the plan is operating according to the most up-to-date policies and provisions. Plan sponsors should take note of the common mistakes that trigger an audit so as to appropriately educate their payroll departments and plan fiduciaries in order to avoid these common pitfalls.

[1] *Iliene H. Ferenczy, The ASPPA Defined Contribution Plan Series, Volume 1, Plan Qualification and Compliance Basics 6th Edition (Arlington, VA, 2015), 11-47*

[2] *Ryk Tierney, CEBS, and James W. Versocki, The Art of Surviving IRS and DOL Audits, http://www.ifebp.org/inforequest/ifebp/0165696.pdf (accessed January 9, 2017)*

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