

**PENNSYLVANIA DEPARTMENT OF REVENUE
ISSUED: JANUARY 16, 2008**

Personal Income Tax Bulletin 2008-1

IRAs

Section 1. Introduction.

1. FEDERAL TAX PERSPECTIVE.

When Congress enacted ERISA in 1974 to regulate employer-sponsored plans, it recognized that the delivery of pension coverage was voluntary on the part of employers. Thus, there would be individuals whose employers would not sponsor pension plans. To encourage individual savings, Congress permitted those individuals to save on their own behalf through individual retirement accounts or annuities (referred to as either conventional or traditional IRAs) without incurring taxes on the original contributions and subsequent earnings until the funds were withdrawn. This vehicle was created under Internal Revenue Code § 408.

In comparison with the maximum limitations for employer-sponsored defined contribution plans (initially the lesser of \$25,000 or 25% of compensation), the initial maximum deductible limits under an IRA were substantially lower (initially the lesser of \$1,500 or 100% of pay). The annual contribution dollar limit was increased to \$1,750 in 1976 for an employee with a non-employed spouse. Eligibility to establish IRAs was expanded in 1981 to include all workers, even those covered by pension plans. The annual contribution limit was also increased to \$2,000. However, as higher-income workers began to take advantage of IRAs, Congress restricted their use in 1986 by permitting tax-deferred contributions to traditional IRAs only for those employees who were not active participants in an employer-sponsored plan and whose adjusted gross income fell below stated thresholds (initially \$40,000 for a couple and \$25,000 for an individual).¹

The tax concept under a traditional IRA was that contributions and related income accumulated tax-free during the years of deferral but became fully taxable when the amounts were actually distributed during retirement. Premature withdrawals from IRAs before age 59½ were subject to a 10% penalty tax, and distributions had to begin by age 70½.

Simplified Employee Plans (SEPs) were added with the Revenue Act of 1978 to encourage small employers to adopt employer-sponsored defined contribution plans with discretionary employer contributions that would be made to each eligible employee's IRA. Annual SEP contributions were limited to the lesser of 15% of compensation or the applicable Internal Revenue Code § 415 defined contribution dollar limit, in comparison with 25% of compensation or the applicable § 415 defined contribution dollar limit. SARSEPs permitted employees to defer a portion of their compensation pre-tax into an IRA for the employee. With

¹ The Taxpayer Relief Act of 1997 increases the income limits for tax-deductible IRAs annually to \$80,000 for couples by 2007 and to \$50,000 for individuals by 2005.

the introduction of SIMPLE Plans in 1997, employers could no longer establish SARSEPs after 1996. The Economic Growth and Tax Relief Reconciliation Act of 2001 increased the annual SEP contribution limit to the same level applicable to qualified defined contribution plans (i.e., the lesser of 25% of compensation or \$40,000 as adjusted for inflation). Thus, it is no longer necessary to establish a SEP in conjunction with a pension plan to maximize the employer's deductible limit of 25%.

A SIMPLE (Savings Incentive Match Plans for Employees) IRA plan (or SIMPLE plan) was added by the Small Business Job Protection Act of 1996 as a vehicle to increase employee contributions under IRAs. If the employer sponsored a SIMPLE plan, employees could make annual contributions to their own IRAs in excess of the annual limit otherwise available under an IRA, but employers would be required to match a portion of the contributions made by the employees or provide a flat contribution. These plans were made available to small employers as an incentive to provide a retirement plan with modest employer contributions and with minimal administrative costs.

The Roth IRA was created by the Taxpayer Relief Act of 1997 and provides a different tax approach to individual savings. While annual contributions to a Roth IRA would not be deductible, all earnings would accumulate tax-free and all distributions would be tax-free upon withdrawal. Because the withdrawn funds are not taxable, there is no penalty tax for early withdrawals and no requirement to force distributions at age 70½ if the individual is still alive. However, while traditional and Roth IRAs are taxed differently, they offer the same tax benefits to a given individual (provided a person's tax rate is the same pre- and post-retirement). However, the eligibility criteria and contribution amounts vary between a traditional and Roth IRA.

The "Deemed IRA" (also called a "Sidecar IRA") was part of "The Economic Growth and Tax Reconciliation Act of 2001," (EGTRRA) although the concept originated in the early 1980's. Basically, if a 401(k) plan adopts this provision of EGTRRA, for plan years beginning on or after January 1, 2003, a 401(k) plan may allow employees to make voluntary employee contributions to a "deemed IRA" which is a separate account established under the plan.

IRA rules apply to all contributions to the deemed IRA. For example, contributions to a deemed Roth IRA will be after-tax. Contribution rules, including deductibility if applicable, for traditional and Roth IRAs apply to all contributions to deemed IRAs, so income thresholds and phase-outs must be taken into consideration when making contributions.

Four main requirements must be satisfied in order to establish a deemed IRA.

- The plan document must provide for the deemed IRA and the plan sponsor must have deemed IRAs in effect no later than the date that deemed IRA contributions are accepted from its employees;
- Only voluntary employee contributions may be made to the deemed IRA;
- The contributions must be made to a separate account or annuity that is

established as part of the qualified plan; and

- The separate account or annuity must meet the requirements for being either a regular or Roth IRA, except that the deemed IRA is exempt from the commingling restrictions.

2. PERSONAL INCOME TAX PERSPECTIVE.

Article III of the Tax Reform Code of 1971 has not explicitly addressed IRAs in any respect. Although Act 2005-40 does reference Roth IRA custodial accounts or employee annuities, the act addresses only when employer contributions are deemed to be received. Accordingly, Departmental regulations have the full force and effect of law with respect to traditional IRAs, SEPs, and other old age or retirement benefit plans that meet the requirements of Internal Revenue Code section 408 and are operated in accordance with those requirements.

Since 1984, the Department's regulations have expressly provided that --

- (1) Contributions to IRAs and SEPs were tax-advantaged only if made to the account of an employee by the employee's employer or labor union;
- (2) Until distributed, income on assets held in an IRA or SEP account is not includible in income; and
- (3) IRA and SEP distributions to an individual, like qualified pension plan distributions, shall be included in income to the extent that contributions were not previously included in income except for either of the following:
 - (I) Distributions made upon or after retirement from service after reaching a specific age or after a stated period of employment.
 - (II) Distributions transferred into another plan, where the transferred amounts are not included in income for Federal income tax purposes.

See 61 PA Code § 101.6(c)(8). Current regulations, however, do not address all of the issues that are unique to these accounts or annuities. The Department proposes to address them by regulation. This bulletin is being published to provide guidance pending the adoption of the regulation.

3. SCOPE.

The taxation of IRAs, Roth IRAs, SEPs, and deemed IRAs under the Personal Income Tax is explained in this Bulletin as follows:

Section 2. Definitions.

Section 3. Employer Contributions.

Section 4. Other Contributions.

Section 5. Non-Deductibility Of Contributions.

Section 6. Income On Plan Assets.

Section 7. Distributions To Plan Participants Under Employer-Sponsored IRAs.

Section 8. Distributions To Plan Participants Under Individual Retirement Investment Accounts.

Section 9. Cost Recovery Method.

Section 10. Distributions To The Beneficiaries Or Estates Of Plan Participants.

Section 11. Special Rules Relating To Terminations, Conversions, Directors Of Corporations, And Elections.

Retirement benefit plan distributions or distributions under other deferred compensation arrangements are beyond the scope of this Bulletin.

Section 2. Definitions.

The following words, terms, and phrases shall have the meaning ascribed to them in this part when used in this bulletin:

Employer-sponsored IRA.

- (1) Accounts established by employers under Internal Revenue Code § 408(c).
- (2) Any individual retirement plan under which all employer contributions to the account of an employee are determined under a definite written allocation formula which specifies the requirements which the employee must satisfy to share in an allocation and the manner in which the amount allocated is computed.
- (3) Simple retirement accounts or SIMPLE IRAs described in IRC § 408(p).
- (4) Simplified employee pensions or SEPs described in IRC § 408(k).

The term shall not include inherited IRAs or deemed IRAs described in IRC § 408(q).

Individual retirement investment account. Any individual retirement plan other than an

employer-sponsored IRA.

Individual retirement plan. An individual retirement account or annuity, section 408(c) IRA, Roth IRA, SEP, SIMPLE IRA or deemed IRA.

Inherited IRA.

(1) An individual retirement plan that becomes the property of a beneficiary as a result of the death of the original owner.²

(2) An inherited IRA beneficiary distribution account or annuity.

The term shall not include a plan that became the property of the original owner's surviving spouse as a result of the death of the original owner if the surviving spouse elects to treat it as his or her own individual retirement plan.

Participant. The individual for whom an individual retirement plan is maintained or the owner thereof. The term shall not include a beneficiary or the estate of a participant.

Section 3. Employer Contributions.

An employer contribution to an individual retirement plan of an employee and the income attributable thereto shall be considered to be compensation received by the employee only when—

- Distributed (see Sections 7 and 8 for taxability of distributions),
- The plan fails to meet Federal requirements, or
- The plan is not operated in accordance with Federal requirements.

Section 4. Other Contributions.

1. EMPLOYEE CONTRIBUTIONS.

An employee's receipt of income shall not be tax-deferred by reason of a contribution of that income to an individual retirement plan through payroll deduction, a cash or deferred arrangement or otherwise.

2. CONTRIBUTIONS BY OR ON BEHALF OF THE SELF-EMPLOYED.

A self-employed individual's receipt of income shall not be tax-deferred by reason of a

² Inherited IRAs are subject to special regulations when the beneficiary is not the decedent's surviving spouse. The beneficiary receives the distribution by December 31 of the fifth year after the death of the owner. In addition, this type of IRA does not allow for tax deduction contributions and rollovers to and from other IRAs. The IRA can also be paid as an annuity or in periodic installments not extending beyond the beneficiary's life expectancy.

contribution of that income directly or indirectly to any individual retirement plan. A self-employed individual includes a partner in a partnership or a member of an LLC.

Section 5. Nondeductibility Of Contributions.

No deduction is allowed to a plan participant for --

- The participant's contribution of compensation, whether direct or indirect, or any other asset to an individual retirement plan, or
- Recontributed or rolled-over amounts.

Section 6. Income On Plan Assets.

Income on assets held in an individual retirement plan is not includible in income until—

- Distributed (see Sections 7 and 8 for taxability of distributions),
- The plan fails to meet Federal requirements, or
- The plan is not operated in accordance with Federal requirements.

Section 7. Distributions To Plan Participants Under Employer-Sponsored IRAs.

All amounts distributed under an employer-sponsored IRA shall be included in compensation to the extent provided in Section 9, "Cost Recovery Method," except--

- Distributions to a former employee made on or after the later of—
 - o The date the former employee attained age 59½, and
 - o The date on which the former employee separated from the service of such employer sponsor, and
- For the year of the transfer, distributions that are transferred into an individual retirement plan or qualified plan where the transferred amounts are not included in income for Federal income tax purposes.

Section 8. Distributions To Plan Participants Under Individual Retirement Investment Accounts.

All amounts distributed from an individual retirement investment account shall be included in compensation to the extent provided in Section 9, "Cost Recovery Method," except--

- Distributions made to a participant after the participant attains age 59½, and

- For the year of the transfer, distributions that are transferred into an individual retirement plan or qualified plan where the transferred amounts are not included in income for Federal income tax purposes.

Section 9. Cost Recovery Method.

The extent to which a distribution is taxable as compensation shall be determined using the cost recovery method of accounting. That accounting method is explained in Personal Income Tax Bulletin 2005-5 (“Qualified Employer Plans”).

Section 10. Distributions To The Beneficiaries Or Estate Of A Plan Participant.

1. GENERAL RULE. Except as provided in paragraphs 2 and 3, all amounts paid under an inherited IRA to the estate, or designated beneficiary, of the plan participant after the death of the plan participant are excludible from tax, including amounts attributable to income on plan assets that accrues after the death of the plan participant.

2. ELECTING SURVIVING SPOUSE. The rules outlined in Section 8 relating to individual retirement investment accounts apply to distributions from an inherited IRA that a surviving spouse elects to treat as his or her own individual retirement plan.

3. ROLLOVERS INTO A SURVIVING SPOUSE’S OWN INDIVIDUAL RETIREMENT PLAN. Any amount rolled over into an individual’s own individual retirement plan on a tax free basis from an IRA that became the property of the individual as a result of the death of the individual’s spouse shall be treated as the individual’s own contribution for tax accounting purposes. The fact or amount of the rollover, however, has no other effect on the taxation of the income on plan assets of, or distributions from, the surviving spouse’s own plan. If the surviving spouse’s plan is an employer-sponsored IRA, the rules outlined in Section 7 shall apply to all distributions; and if it is an individual retirement investment account, the rules outlined in Section 8 shall apply to all distributions.

Section 11. Special Rules Relating To Terminations, Conversions, Directors Of Corporations, And Elections.

1. TERMINATION OF AN INDIVIDUAL RETIREMENT PLAN.

(1) Except as specifically provided in paragraph (2), distributions made upon termination of an individual retirement plan are taxable upon the same basis as other distributions.

(2) Distributions made upon termination of an arrangement that are transferred into a qualified plan or individual retirement plan are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal tax purposes.

2. CONVERSIONS.

The conversion of an individual retirement plan (other than a Roth IRA) to a Roth IRA

shall be treated as a distribution.

3. DIRECTORS OF CORPORATIONS.

For purposes of this bulletin, the terms “employee” and “former employee” shall include the directors and former directors of a corporation.

4. ELECTION TO TREAT AN INHERITED IRA AS A SURVIVING SPOUSE’S OWN INDIVIDUAL RETIREMENT PLAN.

The Pennsylvania Personal Income Tax rules relating to the election to treat an inherited IRA as a surviving spouse’s own individual retirement plan are the same as Federal income tax rules.

An election to treat an inherited IRA as a surviving spouse’s own individual retirement plan shall be deemed to have been made if—

- (1) The surviving spouse redesignates the account as an account in the name of the surviving spouse as owner rather than as beneficiary; or
- (2) At any time, either of the following occurs --
 - (a) Any amount in the inherited IRA that would be required to be distributed to the surviving spouse as beneficiary is not distributed within the time period required under section IRC § 401(a)(9)(B); or
 - (b) Any additional amount is contributed to the inherited IRA which is subject, or deemed to be subject, to the lifetime distribution requirements of IRC § 401(a)(9)(A).