Determining Taxpayer Investment in Retirement Plans and IRAs

By Vorris J. Blankenship

Vorris Blankenship discusses the determination of the return of the nontaxable taxpayer investment in retirement plans and IRAs.

The rules applicable to the taxation of annuity contracts generally apply to benefits distributed by employer retirement plans and IRAs.[1] Thus, an employee or IRA owner does not pay tax on the portion of the retirement plan or IRA distributions representing recovery of his or her investment in "the contract."[2] Although employees and IRA owners use different methods to determine the nontaxable portions of distributions, an employee or owner must in any event first determine his or her total investment in the contract providing the distribution.[3]

The regulations provide that a single employer retirement plan, whether qualified or nonqualified, may consist of more than one contract.[4] Unfortunately, however, use of the term "contract" can be confusing in the context of a plan with two or more contracts that are mere conceptual subdivisions of the plan, with little independent legal significance. For simplicity and logical clarity, this article will refer to separate contracts in retirement plans as "plan programs."

The term "qualified plan" includes, of course, retirement plans and annuities qualifying under Code Secs. 401(a) and 403(a). However, as used in this article, the term also includes tax-sheltered annuities (TSAs) of tax-exempt organizations under Code Sec. 403(b), since employees generally determine their investment in TSAs in much the same way as for qualified plans. The term "nonqualified plan" will refer to plans funded by trusts or annuities that are not qualified plans or eligible governmental plans under Code Sec. 457. The terms "employer retirement plan" and "retirement plan" will include both qualified and nonqualified plans.

Separate Programs Within Retirement Plans

A plan program (a contract) within an employer retirement plan is a separate program of interrelated contributions and benefits that are not interrelated with contributions and benefits under any other separate program.[5] Plan programs include the following:

- Separately determinable retirement benefits and all interrelated contributions (*i.e.,* there could be two or more separate retirement benefit programs in a single employer plan)[6]
- Definitely determinable pre-retirement disability benefits and all interrelated contributions[7]
- Accident and health insurance benefits and all interrelated contributions[8]
- Life insurance benefits and all interrelated contributions[9]
- Retirement income benefits under contracts with insurers and all interrelated contributions[10]
- Endowment benefits under contracts with insurers and all interrelated contributions[11]
- Other benefits that include a life insurance element and all interrelated contributions[12]

For example, an employer retirement plan might require employees to make mandatory contributions toward the purchase of a commercial annuity payable at retirement. At the same time, the plan might allow employees to make voluntary contributions that the plan will hold until retirement and pay out in a lump sum with related earnings. These two arrangements are separate plan programs since contributions to

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each program are interrelated only with distributions from that program.

Of course, many employer retirement plans have only one plan program. In that case, the plan and the plan program are the same, and this article may use the terms interchangeably. For plans with more than one plan program, the focus is normally on each program.

Determining an employee's investment in an employer retirement plan and its separate programs is considerably more difficult than determining a taxpayer's investment in a personally purchased annuity contract. The investment in a personally purchased contract is usually just the consideration paid for it. However, an employee's investment in an employer retirement plan includes different types of employee, employer and plan payments—and excludes other types of such payments. In addition, an employee's investment in the plan may include the value of certain unvested benefits as those benefits vest.

Employee Investment in Qualified Plans

An employee's investment in a plan program that is part of a qualified plan generally equals (1) the total employee contributions allocable to the program, less (2) previous nontaxable recoveries of those contributions.

Employee Contributions

Employee contributions to a qualified plan and its separate programs (in contrast to employer contributions) are generally those contributions previously taxed to the employee or made from the employee's after-tax income. Thus, employee contributions are generally those (1) included in taxable compensation, (2) withheld from taxable compensation, or (3) contributed to the plan from the employee's personal funds.[13] In any event, however, employee contributions specifically include the items described immediately below.

Designated Employee Contributions. Employee contributions include amounts the employer specifically *designates* as employee contributions taxable to the employee. The employer may make the designations in almost any manner.[14] However, the designations are not effective for TSAs[15] nor are they effective for mandatory contributions to a qualified governmental plan that the employer "picks up." An employer picks up a contribution to such a plan by contributing an amount that the employee is otherwise required to contribute—without giving the employee an opportunity to take cash instead.[16]

Contributions Elected by Employee. Employee contributions to qualified plans generally include contributions made at the election of the employee[17]—other than (1) nontaxable cash or deferred contributions under TSAs and 401(k) plans, (2) certain employer matching contributions for employees not self-employed, and (3) contributions under certain unusual one-time irrevocable elections.[18]

Payments of Principal and Interest on Nonqualified Plan Loans. Employee contributions include payments of principal and interest on a plan loan that is *not* a qualified residential loan or a qualified five-year loan.[19] For this purpose, a "qualified residential loan" is a loan subject to strict limitations that the employee uses to acquire a principal residence.[20] A "qualified five-year loan" is a loan repayable within five years that satisfies the same requirements (except for the acquisition of a residence).[21]

Contributions of Nontaxable Income. Employee contributions generally include contributions by an employer that would not have been taxable to the employee if paid directly to him or her.[22] For example, included are contributions for services not subject to U.S. tax because the employee was (1) a nonresident alien performing services outside the United States,[23] or (2) an American Indian exercising fishing rights under treaty.[24]

Contributions of Federal Government Employees. Qualified plans for civilian employees of the federal government include the Civil Service Retirement System (CSRS) and the Federal Employees' Retirement System (FERS).[25] An employee's investment in these plans includes mandatory contributions deducted from the employee's salary checks. The investment also includes any payments the employee made directly to the plan to cover service periods when the government did not deduct mandatory contributions. In addition, the investment includes repayments of previous distributions from the plan (including repayments of interest previously received).[26]

Railroad Retirement Taxes. If an employee receives retirement benefits from the Railroad Retirement Board, the employee must treat a portion of the benefits as if paid by a qualified plan. This portion (known as tier two railroad retirement benefits) is equal to the excess of total benefits over the portion of the benefits taxable as Social Security payments.[27] Consistent with this scheme, railroad retirement taxes paid by an employee are separated into tier one and tier two portions.

The employee treats the tier two portion of the taxes as employee contributions to a qualified plan.[28]

Contributions Allocable to a Plan Program Providing Life Insurance. If an employee is not a self-employed individual, the employee's contributions include the amounts of life insurance premiums paid by the plan that are included in the employee's taxable compensation. For this purpose, an employee's taxable compensation includes premiums paid from funds contributed by the employer or paid from funds earned by the plan. The employee must allocate this deemed contribution amount to the plan program providing the life insurance.[29]

Items Not Considered Employee Contributions

On the other hand, an employee may not treat the following items as employee contributions:

Contributions to Code Sec. 401(k) and Code Sec. 403(b) Plans. The employee's contributions to a TSA or a 401(k) plan do not include certain amounts contributed by the employer that the employee agreed not to receive in cash and that were not taxable to the employee—*i.e.,* amounts contributed under a qualified cash or deferred arrangement.[30]

Contributions While an Expatriate. An employee's contributions generally do not include employer contributions made while the employee was an expatriate that would have been nontaxable foreign earned income if paid directly to the employee—unless the employee was a missionary.[31]

DECs Not Included. An employee's contributions to a plan do not include amounts the employee contributed to the plan and deducted on his or her own tax returns (so-called "deductible employee contributions," or DECs, that were available to some employees in calendar years 1982 through 1986).[32]

Contributions Allocable to Accident and Health Benefits. The plan may have allocated some of the employee's contributions to a plan program providing accident and health insurance benefits. The plan may have made the allocation either (1) when the employee contributed to the plan, or (2) later when the plan paid the benefits. In no event are these contributions allocable to plan programs providing retirement benefits.[33]

Investment Rolled Over from Another Qualified Plan

If the employee's plan is a defined contribution plan qualifying under Code Sec. 401(a), it may also have received employee investment rolled over from another qualified plan in a trustee-to-trustee transfer.[34] To qualify to receive the investment rollover, the plan must have agreed to account separately for both (1) the rolled-over investment, and (2) the amount rolled over in excess of investment.[35]

Previous Recoveries of Employee's Investment

The employee must total (1) his contributions to the plan program, and (2) the investment rolled over to the program from other plans. From that total, the employee must subtract the nontaxable portions of any previous distributions representing a return of his or her investment in the program.[36] For example, the plan may have made a nonannuity distribution to the employee before or at retirement that was a partially nontaxable recovery of the employee's investment in the program.[37] Alternatively, the employee may have received some annuity payments under the program that were also in part a recovery of investment.

In addition, the employee must reduce investment in the plan program by the amount of investment in the program he or she previously rolled over to an IRA or to another qualified plan.[38] If the investment rollover was made to another qualified plan, it could have qualified for rollover only if the rollover were a trustee-to-trustee transfer to a defined contribution plan that qualified under Code Sec. 401(a). The defined contribution plan must also have agreed to account separately (1) for the investment rollover, and (2) for the amount of the rollover in excess of investment.[39]

Whether made to an IRA or to a defined contribution plan, the rollover of investment must also have included the entire amount of the otherwise taxable component of the eligible rollover distribution. Thus, the amount of investment rolled over equals the total amount of the rollover less the otherwise taxable component of the distribution.[40]

Investment in a Plan or Plan Program Illustrated

The following example illustrates the determination of an employee's investment in a plan or one of its separate programs.

> **Example.** Assume that, during an employee's working years, his or her employer paid amounts aggregating $75,000 into a plan account maintained for the employee under a qualified plan program. Assume the employer withheld $25,000 of those contributions from the employee's af-

ter-tax compensation (*i.e.,* from compensation included in the employee's gross income). Assume the employer did not designate any of the remaining $50,000 as employee contributions and that the $50,000 remainder was not otherwise taxable to the employee.

Thus, of the $75,000 total amount paid into the plan account, aggregate amounts of $25,000 are employee contributions (*i.e.,* the employee's investment in the plan program) and aggregate amounts of $50,000 are the employer's contributions. Assume the first distribution under the plan program is a $100,000 lump sum received before the employee's retirement—when the balance of the plan account is $250,000.

After the lump sum distribution, the employee's investment in the program is $15,000—*i.e.,* it is equal to the employee's total contributions of $25,000 *less* the $10,000 partial recovery of the employee's investment from the lump sum distribution. The $10,000 partial recovery of investment is equal to the nontaxable portion of the lump sum distribution.

(Briefly, the $10,000 nontaxable portion of the distribution is equal to the $100,000 lump sum multiplied by 10 percent. The percentage equals the employee's $25,000 contribution to the plan program divided by the $250,000 balance of the plan account.[41])

Special Treatment of Distributions of Employee Contributions

An employee's qualified plan may maintain a separate account for all or part of the employee's contributions and related earnings. If so, the plan may require or allow the employee to take a distribution that draws on only the separate account balance. In that case, the employee may compute his or her investment in the account as if it were a separate plan program (even if the account does not technically qualify as a separate plan program).[42]

Such separate program treatment for employee contributions and related earnings, may allow the employee to accelerate the receipt of nontaxable distributions. That is, the employee may be able to take an immediate distribution of his or her contributions (and related earnings) that consists primarily of a nontaxable return of the employee's investment in the plan. The employee could then take the remainder of his or her benefit (attributable primarily to employer contributions and related earnings) in the form of annuity payments that, though mostly taxable, are receivable in future years.

Alternatively, the employee may achieve a similar result by rolling over plan earnings tax-free to another qualified plan or IRA and personally retaining his or her investment in the plan.[43] Under neither of the alternatives is the investment distributed by the plan subject to the penalty tax on early distributions.[44]

Self-Employed Individual's Investment in a Plan or Plan Program

If an employee is a self-employed individual, the employee's investment in a qualified plan, or a plan program, is generally determined in the same way as for any other employee. However, the individual's investment in the plan or program does not include any amounts used to pay premiums on life insurance or other types of insurance.[45]

Investment Allocable to a Spouse or Former Spouse Under a QDRO

The spouse or former spouse of an employee is generally taxable on a qualified plan payment the spouse receives under a qualified domestic relations order (QDRO) to the extent it is in excess of the spouse's recovery of investment in the plan.[46] For this purpose, the spouse's share of the investment in the plan is equal to the employee's total investment multiplied by a fraction. The fraction is the present value of all the benefits payable to the spouse divided by the present value of the total benefits of the employee and the spouse in the plan.[47]

Investment Due to Plan's Installment Payments of Life Insurance Proceeds

A qualified plan that receives life insurance proceeds on the death of an employee may be obligated to pay the proceeds to plan beneficiaries.[48] If so, and if the plan satisfies its obligation by making installment payments to the beneficiaries, the beneficiaries may add the amount of the nontaxable insurance proceeds to the investment in the plan program providing the life insurance.[49]

Investment Allocable to Distributed Annuity or Life Insurance Contracts

Determination of an employee's investment in an annuity or life insurance contract distributed by a qualified plan is a separate subject rife with uncertainty. There does not appear to be, for example, any direct authority or other guidance stating whether an employee may allocate plan investment to a distributed nontransferable annuity contract. The author intends to deal with this question and related questions in a separate article.

Employee Investment in Nonqualified Plans

An employee generally determines his or her investment in a nonqualified plan program by subtracting previous nontaxable program distributions from the sum of (1) the employee's contributions to the program, (2) previously taxed employer contributions, and (3) previously taxed program earnings. More specifically:

1. Value of Plan Interest When First Taxed

The employee must generally determine the value of his or her interest in the plan program when the interest first became taxable.[50] That is, the employee must generally determine the value of the interest on the earliest of (1) the date the employee received a vested interest, (2) the date the employee received an unvested interest if he or she elected to pay tax on it, or (3) the date the interest became vested.[51] Generally, the value of the interest on that date is the same as the amount that was taxable to the employee on that date.

Nevertheless, if the employee is a "highly compensated employee" participating in a "discriminatory" plan funded by a trust, the employee must generally determine the value of his or her interest on the last date it was taxable to him or her. That date would normally be December 31 of the preceding year. For this purpose, a plan is "discriminatory" if it does not satisfy the requirements of Code Sec. 401(a)(26) or 410(b).[52]

Whether an employee is a "highly compensated employee" depends on the employee's status (1) when the employee received credit for service under the plan, (2) during the employee's working years after age 55, or (3) when the employee terminated employment.[53] The employee is generally a highly compensated employee if at any such time he or she directly or indirectly owned more than five percent of the employer. Alternatively, the employee is a highly compensated employee if at any such time his or her compensation exceeded a specific dollar threshold and ranked the employee among the highest paid 20 percent of a specified group of employees.[54]

2. Value of Subsequent Employer Contributions

The employee must then determine the value of each subsequent employer contribution allocable to the plan program on the date the contribution became taxable to the employee.[55] That is, the employee must determine the value of the contribution on the earliest of (1) the date the plan received it if it was then vested, (2) the date the plan received it if it was not vested but the employee elected to pay tax on it, or (3) the date the contribution became vested.[56] Again, the value of the contribution on that date is generally the amount that was taxable to the employee on that date.

3. Employee Contributions to the Plan

The employee must determine the total amount of any contributions he or she made to the plan that were allocable to the plan program.[57] For this purpose, the employee's contributions (except those of a self-employed individual) include the amount of any employer contributions allocated to life insurance premiums and included in the employee's taxable compensation.[58]

Plan Loans to the Employee. All loans to an employee by a nonqualified plan (other than a former qualified plan or government plan) are taxable as distributions.[59] An assignment or pledge of an employee's interest in such a plan is also taxable as a distribution.[60] However, the taxable amount of the loan, assignment or pledge increases the employee's investment in the plan (although the investment is unaffected by the portion of the loan that is a nontaxable return of investment). Repayments of the loan have no impact on investment in the plan.[61]

Contributions of Nontaxable Income. Employee contributions to a nonqualified plan also generally include contributions that would not have been taxable to the employee if paid directly to him or her.[62] Thus, similar to qualified plans, employee contributions include contributions for services not subject to U.S. tax because the employee was (1) a nonresident alien performing services outside the United States,[63] or (2) an American Indian exercising fishing rights under treaty.[64]

Contributions Excluded from Investment. As with qualified plans, an employee's contributions to a nonqualified plan generally do not include employer contributions made while the employee was an expatriate that would have been nontaxable foreign earned income if paid directly to the employee—unless the employee was a missionary.[65] Furthermore, an employee may not treat contributions properly allocated to a separate program providing accident and health insurance benefits (*e.g.,* medical or disability benefits) as part of the employee's investment in retirement benefits.[66]

4. Additional Rules for Former Qualified Employer Plan or Government Plan

If the nonqualified plan was formerly a qualified plan, the employee must use qualified plan rules to determine his or her investment in the plan as of the end of the employer's last tax year that ends on or before the first nonqualified plan year. Thereafter, the employee must apply the nonqualified plan rules under items 1 through 3 above to determine additional investment in the plan (but in all events excluding the amount of plan appreciation vested before the plan's disqualification).[67]

In addition, employee contributions to former qualified plans and nonqualified government plans include all payments of principal and interest on a plan loan that is not a qualified residential loan or a qualified five-year loan.[68] (Consequently, the employee does not increase his or her contributions by the amount of the taxable loan proceeds received—as for other nonqualified plans.)

5. Previous Return of Some or All of the Employee's Investment

From the sum of items 1 through 4 above, the employee must subtract the portion of previous distributions representing a return of his or her investment in the plan program.[69] For example, the plan may have made a nonannuity distribution that involved a return of some of the employee's investment. Alternatively, the employee may have received annuity payments that were in part a return of his or her investment.

6. Guaranteed Annuity Payments

If a plan program provides an annuity with guaranteed payments (in the nature of a refund of the amount paid for the annuity), the employee must also subtract the value of the guaranteed payments from the sum of 1 through 4 above. However, this adjustment applies only in determining the nontaxable portion of annuity payments.[70] It does not apply in determining the nontaxable portion of a nonannuity payment.[71]

Guaranteed payments are the minimum number of payments required under a life annuity contract, determined without regard to how long the employee or his or her beneficiaries live.[72] The employee computes the value of the guaranteed payments by multiplying (1) the smaller of (a) the total amount of the guaranteed payments, or (b) the amount of the employee's investment in the plan program; by (2) an actuarial percentage.[73]

The actuarial percentage depends on (1) the number of years the issuer guarantees the payments, and (2) the age of the employee (and beneficiaries) at the annuity starting date. The employee finds the actuarial percentage for a single life annuity in Table VII, Percent Value of Refund Feature, in the regulations if the employee and employer contributed all the funds to the plan program after June 30, 1986. If the employee and employer contributed all the funds for the annuity on or before June 30, 1986, the employee finds the actuarial percentage in Table III, Percent Value of Refund Feature.[74]

Otherwise, if the employee or employer contributed funds to the plan program both before and after June 30, 1986, the employee may treat the entire investment as made after June 30, 1986. Alternatively, for a single life annuity, the employee may make a special computation using both Tables III and VII. Under this computation, the value of the guaranteed payments is the sum of (1) the amount computed by applying the Table III percentage to the pre–July 1, 1986, investment, and (2) the amount computed by applying the Table VII percentage to the post–June 30, 1986, investment.[75]

If an annuity with guaranteed payments is payable over two or more lifetimes, the computation of the value of the guaranteed payments must generally be determined using the somewhat more complex mathematical formulas set forth in the regulations.[76]

Investment in a Plan or Plan Program Illustrated

The following example illustrates the determination of an employee's investment in a nonqualified plan that provides only a purchased lifetime annuity with guaranteed payments.

> **Example 1.** Assume that on July 1, 2004, an employer purchased a fully vested lifetime annuity contract for an employee under a nonqualified plan. The purchase price was $100,000 (taxable to the employee at the time of the

purchase). Assume the issuer began making monthly payments of $500 when the employee retired at age 65. Assume further that the issuer guaranteed 60 monthly payments even if the employee should die before he or she received 60 payments.

Then, for purposes of computing the nontaxable portion of the employee's annuity payments, the investment in the annuity is $99,100. The employee determines the $99,100 investment by subtracting (1) the $900 amount attributable to the 60 guaranteed payments, from (2) the $100,000 cost of the annuity. The $900 amount is equal to (1) the *lesser* of (a) the $30,000 total amount of the 60 guaranteed payments, or (b) the $100,000 cost of the annuity; multiplied by (2) three percent. Table VII provides this percentage for 60 monthly payments (five years of payments) guaranteed to a person age 65.

The following example illustrates how to determine an employee's investment in a nonqualified plan that accumulates employer and employee contributions in a trust.

Example 2. Assume an employer made a contribution of $90,000 into a trust account maintained for a non–highly compensated employee under a nonqualified plan program. The contribution was forfeitable if the employee did not complete two years of employment after the date of contribution. When the employee completed the two years of employment, the total value of the funds in the trust account had grown to $130,000. At that time, the employee's interest in the program vested and the employee paid tax on the $130,000 value of his or her interest.

Assume the employee contributed $20,000 to the plan program from the employee's own after-tax income. Thus, the previously taxed portion of the employee's interest was $150,000 (the employee's $20,000 direct contribution *plus* the $130,000 value when his or her interest vested). This $150,000 amount, then, was the employee's investment in the program.

Assume the program subsequently made a $125,000 lump sum distribution to the employee before retirement when the balance of the employee's trust account was $250,000 and the employee's investment still equaled $150,000.

After the lump sum distribution, the employee's investment in the program is $125,000—*i.e.,* it is equal to the employee's $150,000 original investment *less* the $25,000 partial recovery of his or her investment from the lump sum distribution. This $25,000 partial recovery of investment is the same as the nontaxable portion of the lump sum distribution.[77]

Trust Purchasing and Distributing an Annuity

If a trust under a nonqualified plan purchases and distributes an annuity contract, the employee's initial investment in the contract is equal to the value of the contract on the date distributed.[78] The employee must then adjust the investment for subsequent premium payments and distributions. In addition, the investment recoverable from annuity payments must take into account any guaranteed payments described in item 6 above.

Example 3. Assume an employer made vested contributions of $80,000 to an employee's separate trust account in a nonqualified plan program, and that the account balance grew to $200,000 by the time the employee retired at age 65. Assume the program used the entire $200,000 balance to purchase and immediately distribute an annuity contract payable for the employee's lifetime. (The $200,000 value of the annuity contract, less the $80,000 previously taxed to the employee, is taxable to the employee when the plan distributes the contract.)

Assume further that the issuer began making monthly payments of $1,000 to the employee when he retired—with at least 60 payments guaranteed. Then, for purposes of determining the nontaxable portion of the annuity payments, the investment in the annuity is $198,200. The employee determines the $198,200 investment by subtracting (1) $1,800 attributable to the 60 guaranteed payments, from (2) the $200,000 cost of the distributed annuity. The $1,800 amount attributable to the guaranteed payments is equal to the lesser of

(1) the $60,000 total amount of the 60 guaranteed payments, or (2) the $200,000 cost of the annuity—multiplied by three percent. Table VII provides this percentage for 60 monthly payments (five years of payments) guaranteed to a person age 65.

Investment Stated in Foreign Currency

An employee must convert investment stated in foreign currency to U.S. currency using the various rates of exchange existing when the investment originated. If those rates of exchange are unknown and unascertainable, the employee may convert the foreign currency at the rate of exchange in effect on the employee's annuity starting date.[79]

Investment of an IRA Owner

As with employer retirement plans, distributions from traditional IRAs are generally taxable only to the extent they are in excess of the recovery of the IRA owner's investment.[80] However, an IRA owner with two or more IRAs must generally aggregate investments in all of his or her IRAs to determine the taxable and nontaxable portions of IRA distributions.[81] The owner aggregates these investments for a particular tax year by subtracting the nontaxable portions of distributions in previous tax years from the total of the owner's nondeductible (after-tax) contributions for all years.

1. Aggregate Nondeductible Contributions

The IRA owner must determine the total amount of all nondeductible contributions to the owner's IRAs for the current tax year and all previous years.[82] The owner will likely know which of his or her contributions were deductible and which were nondeductible—or he or she may determine the deductible contributions (and thus the nondeductible contributions) by examining prior year tax returns.[83] If an employer makes a direct contribution to an employee's IRA, the tax law generally treats the contribution as (1) received by the employee as taxable income and then (2) contributed to the IRA by the employee as either a deductible or a nondeductible contribution.[84] However, the tax law generally treats contributions by an employer to a SEP or Simple IRA as a deductible contribution.[85]

2. Investment Rolled Over from Qualified Plan

If all or part of an IRA balance consists of funds rolled over tax-free from a qualified plan, the rollover from the plan may contain investment. To determine the amount of investment rolled over from the plan, the IRA owner must first compute the total amount of his or her investment in the plan program providing the rollover (as explained earlier in this article).

Then, the owner must determine how much of the total investment in the plan program was properly includible in his or her eligible rollover distribution from the plan. This investment component of the distribution is generally equal to the amount of the distribution multiplied by the plan program's exclusion percentage. The exclusion percentage is generally the investment in the plan program divided by the program's nonforfeitable account balance.[86]

After determining the investment component of the eligible rollover distribution from the qualified plan, the IRA owner must determine the portion of the investment component that he or she rolled over to his or her IRA. In this connection, the rollover must first include the entire amount of the otherwise taxable component of the eligible distribution (*i.e.*, the portion of the distribution in excess of the investment component) before including any portion of the investment component. Consequently, the amount of any investment rolled over necessarily equals the total amount of the rollover less the otherwise taxable component of the eligible rollover distribution.[87]

3. Reduction for Prior Recovery of Investment

From the sum of 1 and 2 above, the owner deducts the portion of each prior year IRA distribution that represented a nontaxable recovery of his or her investment.[88] However, amounts transferred in tax-free rollovers from one IRA to another IRA do not affect an owner's aggregate investment in his or her IRAs. First, the rollover of the entire amount of a distribution from one IRA to another IRA simply transfers investment between IRAs without changing aggregate investment. Second, if the owner rolls over to another IRA only a portion of an IRA distribution, the portion of the distribution rolled over automatically carries with it the appropriate *pro rata* part of aggregate investment.[89]

Nor do amounts rolled over tax-free from IRAs to qualified plans directly affect the owner's investment in his IRAs. Such rollovers may not include investment.[90] However, the IRA distribution that is the source of the rollover will normally contain an investment component that the owner must personally retain.[91] Since the tax law requires an owner to treat such a rollover distribution as separate from other IRA distributions,[92] the owner should immediately reduce the aggregate investment in his or her IRAs by the amount of the retained investment portion of the rollover distribution.[93]

Investment in an IRA Illustrated

The following example illustrates the determination of an owner's total investment in all his or her IRAs.

> **Example.** Assume an employee retired in July 2005, when she had an investment of $50,000 in her qualified plan. Assume that, in October 2005, she received a distribution of the entire $400,000 balance in the plan (before reduction by mandatory 20-percent income tax withholding[94]), and she immediately rolled over $380,000 to a new IRA (a "rollover IRA"). Thus, she retained $20,000 of the nontaxable recovery of investment and transferred the remaining $30,000 of the investment to her rollover IRA.
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> Assume further that, prior to retirement, the employee had also made nondeductible contributions of $10,000 directly to another IRA (a "contributory IRA"). Assume she received a $5,000 distribution from the contributory IRA in 2004 (*i.e.,* in the prior year) and the nontaxable recovery of investment included in the distribution was $2,000.
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> Then, the employee's total investment in her IRAs at December 31, 2005 was $38,000 ($30,000 in the rollover IRA *plus* $10,000 in the contributory IRA *less* the $2,000 recovery of investment in 2004).

Alternatively, the employee in the above example could have chosen to roll over tax-free to the IRA an amount exactly equal to the $350,000 portion of the plan distribution that was otherwise taxable. Then the employee could have retained tax-free the $50,000 remainder of the distribution (representing her entire investment in the plan).[95] The employee could also have accomplished the same thing in a trustee-to-trustee transfer by directing the trustee to (1) transfer to the IRA all funds in excess of her investment, and (2) as a part of the same transaction, distribute to her the remaining funds representing her investment.[96]

Investment of a Roth IRA Owner

If a Roth IRA makes only "qualified distributions" to an owner or beneficiary, the distributions are entirely nontaxable and the owner's investment is largely irrelevant.[97] However, if a Roth IRA should make a nonqualified distribution, it does become necessary to determine the owner's total investment and his or her nontaxable recovery of that investment.[98] Fortunately, in those situations, the owner always recovers all of his or her total investment in Roth IRAs tax-free before the remaining portion of a nonqualified distribution becomes taxable.[99]

To some extent, an owner's investment in a Roth IRA is determined in the same way as an owner's investment in a traditional IRA. Similar to a traditional IRA owner, a Roth IRA owner must determine the investment in all his or her Roth IRAs by aggregating all the owner's Roth IRA investments.[100] However, unlike the owner of a traditional IRA, a Roth IRA owner generally may not make deductible contributions or nontaxable rollovers to a Roth IRA (other than from another Roth IRA).[101] Thus, an owner's investment in his or her Roth IRAs generally equals the actual total amount of (1) his or her nondeductible contributions, and (2) all "qualified rollover contributions" from traditional IRAs (*i.e.,* taxable Roth conversions).

The tax law may impose the 10-percent penalty tax for early distributions on all or part of a nonqualified distribution by a Roth IRA—including all or part of the nontaxable recovery of investment. To compute the penalty (if it is applicable), the owner of a Roth IRA must segregate contributions by year and type of contribution. Thus, a Roth IRA owner potentially subject to the penalty should maintain records that show the amount and year of each of his or her nondeductible contributions and the taxable and nontaxable amounts of each prior year's conversion of a traditional IRA to a Roth IRA.[102]

Summary

The statutory scheme of treating distributions under employer retirement plans as if they were distributions under annuity contracts can be confusing. It is not a perfect fit. An annuity contract is a self-contained collection of interrelated legally enforceable rights and obligations generally satisfying the single purpose of providing a stream of income. On the other hand, an employer retirement plan may contain two or more separate programs with little independent legal significance, each satisfying a different purpose. The drafters of the regulations tried to reconcile these differences by analogizing separate plan programs to separate annuity contracts. Thus, they created a need to allocate an employee's plan investment to separate plan programs.

For qualified plan programs, an employee's total investment (before distributions) generally consists of allocated plan contributions previously taxed to the employee or made from the employee's after-tax income. For nonqualified plan programs, an employee's investment (before distributions) generally consists of the sum of (1) the allocated employee contributions, (2) previously taxed employer contributions allocated to the program, and (3) any previously taxed program earnings. Nevertheless, a number of special rules applicable to qualified or nonqualified plans may modify these general rules.

An IRA owner must aggregate the investment in all his or her IRAs before using the total investment to determine the nontaxable portions of IRA distributions. Investment included in the aggregation generally consists of nondeductible IRA contributions and investment rolled over from qualified plans. If an owner does roll over funds from a qualified plan to his or her IRA, the owner generally has the option of (1) including his or her plan investment in the rollover, or (2) personally retaining the investment tax-free.

"Qualified distributions" by Roth IRAs are nontaxable without regard to investment. However, if a Roth IRA makes a nonqualified distribution, the owner must determine his or her total investment in all Roth IRAs and the nontaxable recovery of that investment. Fortunately, in those situations, the owner always recovers all of his or her total investment in the Roth IRAs tax-free before the remaining portion of the distribution becomes taxable. However, in some such cases, the tax law may impose the 10-percent penalty tax for early distributions on all or part of the distribution—including all or part of the nontaxable recovery of investment.

Endnotes

1 Code Sec. 402(a), (b)(2); Code Sec. 403(a)(1), (b)(1), (c); Code Sec. 408(d)(1).
2 Code Sec. 72(b)(1), (d)(1), (e)(2), (e)(5), (e)(8).
3 Code Sec. 72(c)(1), (c)(2), (d)(1)(C), (e)(6).
4 Reg. §1.72-2(a)(3)(i).
5 *Id.*
6 Reg. §1.72-2(a)(3)(ii)(a).
7 Reg. §1.72-2(a)(3)(ii)(b).
8 Reg. §1.72-2(a)(3)(ii)(d).
9 Reg. §1.72-2(a)(3)(ii)(c).
10 Reg. §1.72-2(a)(3)(ii).
11 *Id.*
12 *Id.*
13 Code Secs. 72(c)(1)(A), 72(f)(1), 403(c); Reg. §1.72-8(a)(1), (5); *F.F. Foil*, CA-5, 91-1 USTC ¶50,016, 920 F2d 1196; *Steel Balls, Inc.*, 69 TCM 2912, Dec. 50,698(M), TC Memo. 1995-266, *aff'd per curiam without published opinion*, CA-8, 96-1 USTC ¶50,309, 89 F3d 841.
14 Code Sec. 414(h)(1); Reg. §1.401(k)-1(a)(2)(ii); *Foil, supra* note 13; *Steel Balls, Inc., supra* note 13.
15 Code Sec. 414(h)(1).
16 Reg. §1.72-8(a)(1); Reg. §1.72-8(a)(5).
17 Code Sec. 72(f)(1); Reg. §1.402(a)-1(d)(1).
18 Code Secs. 401(a)(30), 401(k), 402(g)(3) , 402(g)(8), 403(b)(1)(E); Reg. §§1.402(a)-1(d)(2), 1.401(k)-1(a)(2)(ii).
19 Reg. §1.72(p)-1, Q&A 21.
20 Code Sec. 72(p)(2)(B)(ii), (2)(C); Reg. §1.72(p)-1, Q&A 4(a).
21 Code Sec. 72(p)(2).
22 Code Sec. 72(f)(2).
23 Code Sec. 872(a).
24 *R.A. Hall*, 76 TCM 473, Dec. 52,881(M), TC Memo. 1998-336.
25 Rev. Rul 70-150, 1970-1 CB 106; *J.E. Shimota*, ClsCt, 90-2 USTC ¶50,489, 21 ClsCt 510, *aff'd*, CA-FC, 91-2 USTC ¶50,477, 943 F2d 1312, *cert. denied*, SCt, 503 US 984, 112 SCt 1669 (1992); IRS Publication 721.
26 Code Secs. 72(c)(1)(A), 414(h)(1); Reg. §1.401(k)-1(a)(2)(ii); Rev. Rul. 70-314, 1970-1 CB 20; IRS Publication 721.
27 Code Secs. 72(r)(1), 72(r)(3), 86(d)(4).
28 Code Sec. 72(r)(2).
29 Reg. §§1.72-16(b)(2), 1.72-16(b) (4), 1.72-8(a)(1), 1.403(b)-1(c)(3). If the terms of a plan do not expressly allocate employee contributions to life insurance premiums, the plan must first apply employer contributions and trust income to the premiums before applying employee contributions. Rev. Rul. 68-390, 1968-2 CB 175.
30 Code Secs. 401(k); 403(b); 402(g).
31 Code Sec. 72(f).
32 Code Sec. 72(o)(1), (5); DECs were enacted by P.L. 97-34, §311(a); Repealed by P.L. 99-514, §1101(b)(1).
33 Reg. §1.72-15(c).
34 The Internal Revenue Code nowhere expressly states that investment rolled over from a qualified plan to another qualified plan or IRA decreases the taxpayer's investment in the distributing plan and increases his or her investment in the recipient plan or IRA. However, the taxpayer contributes the investment to the recipient plan or IRA after receiving it directly or indirectly as a nontaxable (or after-tax) component of a plan or IRA distribution. In this connection, it is clear that the tax law treats contributions of after-tax amounts to a plan or IRA as taxpayer investment. Code Sec. 72(c)(1), (e)(6), (f)(1); Reg. §1.72-8(a)(1), (5); *Foil, supra* note 13; *Steel Balls, Inc., supra* note 13; Notice 87-16, 1987-1 CB 446, Q&A D4.
35 Code Secs. 402(c)(2)(A), 401(a)(31)(C)(i).
36 Code Sec. 72(c)(1)(B).
37 *E.g.,* an in-service distribution to an employee over age 59 1/2, or a lump sum distribution in connection with the commencement of annuity payments. *See* Code Sec. 72(d)(1)(D), (t)(2)(A)(i).
38 Code Sec. 402(c)(2). *Also, see supra* note 34.
39 Code Secs. 402(c)(2)(A), 401(a)(31)(C)(i).
40 Code Sec. 402(c)(2).
41 Code Sec. 72(e)(8)(A)-(C).
42 Code Sec. 72(d)(2). Although this statutory provision applies only to defined contribution plans, the tax law treats any separate account in a defined benefit plan as if it were a defined contribution plan for this purpose. Code Sec. 414(k)(2). *C.f.,* Notice 87-13, 1987-1 CB 432. This notice interprets a previously repealed version of Code Sec. 72(e)(9). However, the language of the previously repealed section is almost identical to that of present-day Code Sec. 72(d)(2).

[43] Code Sec. 402(c)(2).

[44] Code Sec. 72(t)(1) provides that the penalty tax on early distributions may be imposed only on the taxable portion of a distribution (and thus not on the investment portion).

[45] Code Sec. 72(m)(2) flatly states that investment in a plan does not include any plan *contributions* allocated to the cost of insurance that were contributed while the employee was an "owner-employee." Code Sec. 72(m)(2) defines an owner-employee to include a self-employed individual under Code Sec. 401(c)(1). Although Code Sec. 72(m)(3)(B) provides that the cost of insurance paid from *plan income* is taxable (even to a self-employed individual), there is no provision allowing the individual to add the taxed plan income to the individual's investment in the plan. Although Code Sec. 72(f)(1) provides that *employer contributions* that are taxable to an employee are generally included in the employee's investment, *plan income* would not appear to constitute employer contributions for this purpose. The foregoing tax treatment of plan insurance held for a self-employed individual appears generally consistent with the tax treatment of insurance held directly by the individual. That is, whether the plan or the self-insured individual holds the insurance, the individual does not get any deduction for the payment of insurance premiums. In addition, tax-deferred plan income that the plan in effect distributes to the individual to pay premiums is taxable to the individual without constituting additional investment in the plan.

[46] Code Sec. 402(e)(1)(A); IRS Publication 504. State community property laws do not change this result. *L.D. Seidel*, 89 TCM 972, Dec. 55,977(M), TC Memo. 2005-67.

[47] Code Sec. 72(m)(10).

[48] Reg. §1.72-16(b)(1).

[49] LTR 9618028 (Feb. 6, 1996).

[50] Reg. §1.402(b)-1(b)(5).

[51] Code Sec. 83(a), (b); Reg. §1.83-1(a)(1).

[52] Code Sec. 402(b)(4).

[53] Code Secs. 402(b)(4)(C), 414(q)(6).

[54] Code Sec. 414(q)(1).

[55] Reg. §1.402(b)-1(b)(5).

[56] Code Sec. 83(a), (b); Reg. §1.83-1(a)(1).

[57] Reg. §1.83-4(b)(1).

[58] Code Sec. 72(f)(1); Reg. §1.72-8(a)(1).

[59] Code Sec. 72(e)(4)(A)(i), (p)(4).

[60] Code Sec. 72(e)(4)(A)(ii).

[61] Code Sec. 72(e)(4)(A).

[62] Code Sec. 72(f)(2).

[63] Code Sec. 872(a).

[64] *Hall*, *supra* note 24.

[65] Code Sec. 72(f).

[66] Reg. §1.72-15(c).

[67] Reg. §1.402(b)-1(b)(1), (5).

[68] Code Sec. 72(p)(1), (4); Reg. §1.72(p)-1, Q&A 21.

[69] Code Sec. 72(c)(1)(B).

[70] Code Sec. 72(c)(2).

[71] Code Sec. 72(e)(6).

[72] Code Sec. 72(c)(2).

[73] Reg. §1.72-7(b)(3).

[74] Reg. §§1.72-7, 1.72-9, Tables III and VII.

[75] Reg. §§1.72-6(d)(6), 1.72-7(b)(4), Example (3).

[76] Reg. §1.72-7(c).

[77] Since this is a nonqualified plan, the distribution is taxable to the employee to the extent of the *lesser* of (1) the $125,000 excess of the balance of the plan account over the employee's investment, or (2) the $150,000 total amount of the distribution. Thus, $125,000 of the distribution is taxable and the remaining $25,000 of the distribution is a nontaxable recovery of investment. Code Secs. 72(e)(2)(B), 72(e)(3), 402(b)(2).

[78] Reg. §1.402(b)-1(c)(1).

[79] Rev. Rul 58-236, 1958-1 CB 37.

[80] Code Secs. 408(d)(1), 72.

[81] Code Sec. 408(d)(2); Notice 87-16, 1987-1 CB 446.

[82] Code Sec. 72(c)(1)(A); *G. Campbell*, 108 TC 54, Dec. 51,884 (1997); H. Conf. Rept. 99-841, at II-379 (1986), 1986-3 CB (Vol. 4) at 379.

[83] Code Secs. 408(a)(1), 408(b)(2)(B), 219.

[84] Code Sec. 219(f)(5).

[85] Code Secs. 402(k), 219(b)(2), 219(b)(4).

[86] Code Sec. 72(e)(8)(A)-(C). The nonforfeitable account balance does not include net unrealized appreciation on employer securities purchased with employee contributions. Notice 89-25, 1989-1 CB 662, Q&A 1.

[87] Code Sec. 402(c)(2).

[88] Code Sec. 72(e)(6)(B).

[89] Notice 87-16, 1987-1 CB 446, D4.

[90] Code Sec. 408(d)(3)(A)(ii).

[91] Code Secs. 72, 408(d)(1), (2).

[92] Code Sec. 408(d)(3)(H)(ii)(I).

[93] Code Sec. 408(d)(3)(H)(ii)(III).

[94] Code Sec. 3405(c)(1). Under the Federal Insurance Contributions Act (FICA), qualified plans are not required to withhold Social Security tax from distributions to participants and beneficiaries. Code Sec. 3121(a)(5)(A)–(C).

[95] Code Sec. 402(c)(2).

[96] Code Secs. 401(a)(31), 402(c)(2); Reg. §1.401(a)(31)-1, Q&A 9.

[97] Code Sec. 408A(d)(1).

[98] Code Sec. 408A(a).

[99] Code Sec. 408A(d)(4)(B).

[100] Code Secs. 408A(d)(4)(A), 408(d)(2).

[101] Code Sec. 408A(c)(1), (c)(6)(A).

[102] Code Secs. 72(t), 408A(d)(3)(F), 408A(d)(4)(B).