

Part Four.

Adjustments to Income

The three chapters in this part discuss some of the adjustments to income that you can deduct in figuring your adjusted gross income. These chapters cover:

- Contributions you make to traditional individual retirement arrangements (IRAs) — chapter 17,
- Alimony you pay — chapter 18, and
- Student loan interest you pay—chapter 19.

Other adjustments to income are discussed elsewhere. See Table V below.

Table V. Other Adjustments to Income

Use this table to find information about other adjustments to income not covered in this part of the publication.

IF you are looking for more information about the deduction for...	THEN see...
Certain business expenses of reservists, performing artists, and fee-basis officials	Chapter 26.
Contributions to a health savings account	Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans.
Moving expenses	Publication 521, Moving Expenses.
One-half of self-employment tax	Chapter 22.
Self-employed health insurance	Chapter 21.
Payments to self-employed SEP, SIMPLE, and qualified plans	Publication 560, Retirement Plans for Small Business.
Penalty on the early withdrawal of savings	Chapter 7.
Contributions to an Archer MSA	Chapter 21.
Reforestation amortization or expense	Chapter 9 of Publication 535, Business Expenses.
Contributions to Internal Revenue Code section 501(c)(18)(D) pension plans	Publication 525, Taxable and Nontaxable Income.
Expenses from the rental of personal property	Chapter 12.
Certain required repayments of supplemental unemployment benefits (sub-pay)	Chapter 12.
Foreign housing costs	Chapter 4 of Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad.
Jury duty pay given to your employer	Chapter 12.
Contributions by certain chaplains to Internal Revenue Code section 403(b) plans	Publication 517, Social Security and Other Information for Members of the Clergy and Religious Workers.
Attorney fees and certain costs for actions involving certain unlawful discrimination claims	Publication 525.
Domestic production activities deduction	Form 8903.

17.

Individual Retirement Arrangements (IRAs)

What's New for 2006

Traditional IRA contribution and deduction limit. If you were age 50 before 2007, the most that could be contributed to your traditional IRA for 2006 is the smaller of the following amounts:

- \$5,000, or
- Your taxable compensation for the year.

Nontaxable combat pay. Beginning in 2004, you can treat nontaxable combat pay as compensation for purposes of the limits on contributions and deduction of contributions to IRAs. You may be able to amend your 2004 or 2005 return. For more information, see *Nontaxable combat pay* under *When Can Contributions Be Made?*

Qualified reservist repayments. If you are (or were) a member of a reserve component and you were ordered or called to active duty after September 11, 2001, you may be able to repay certain early distributions even if the repayment would cause your total contributions to be more than the limit on contributions. See *Qualified reservist repayments* under *How Much Can Be Contributed?*

Modified AGI limit for traditional IRA contributions increased. For 2006, if you were covered by a retirement plan at work, your deduction for contributions to a traditional IRA is reduced (phased out) if your modified adjusted gross income (AGI) is:

- More than \$75,000 but less than \$85,000 for a married couple filing a joint return or a qualifying widow(er),
- More than \$50,000 but less than \$60,000 for a single individual or head of household, or
- Less than \$10,000 for a married individual filing a separate return.

Qualified charitable distributions. If you were at least age 70½ and you had a distribution made by the trustee of your IRA directly to a charitable organization, it may be nontaxable. See *Qualified charitable distributions* under *Are Distributions Taxable?*

Qualified reservist distributions. If you are (or were) a member of a reserve component and you were ordered or called to active duty after September 11, 2001, you may not have to pay the 10% tax on early distributions you received after you were ordered or called to active duty. See *Qualified reservist distributions* under *Early Distributions* in Publication 590, *Individual Retirement Arrangements*.

Rollovers from designated Roth accounts. If any part of an eligible rollover distribution is from a designated Roth account set up under an employee's qualified plan, you can roll over, tax free, that part of the distribution to another designated Roth account or to a Roth IRA.

Roth IRA contribution limit. If you were age 50 or older before 2007 and contributions on your behalf were made only to Roth IRAs, your contribution limit for 2006 is generally the lesser of:

- \$5,000, or
- Your taxable compensation for the year.

However, if your modified adjusted gross income (AGI) is above a certain amount, your contribution limit may be reduced.

Qualified Roth contribution programs. For tax years beginning after 2005, a qualified cash or deferred arrangement (section 401(k) plan) or a tax-sheltered annuity plan (section 403(b) plan) can create a qualified Roth contribution program so that participants can elect to have part or all of their elective deferrals to the plan designated as after-tax Roth contributions. For more information about 401(k) plans, see Publication 560, *Retirement Plans for Small Business*. For more information about 403(b) plans, see Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans)*.

Reminders

Statement of required minimum distribution. If a minimum distribution is required from your IRA, the trustee, custodian, or issuer that held the IRA at the end of the preceding year must either report the amount of the required minimum distribution to you, or offer to calculate it for you. The report or offer must include the date by which the amount must be distributed. The report is due January 31 of the year in which the minimum distribution is required. It can be provided with the year-end fair market value statement that you normally get each year. No report is required for IRAs of owners who have died.

IRA interest. Although interest earned from your IRA is generally not taxed in the year earned, it is not tax-exempt interest. Do not report this interest on your tax return as tax-exempt interest.

Form 8606. If you make nondeductible contributions to a traditional IRA and you do not file Form 8606, *Nondeductible IRAs*, with your tax return, you may have to pay a \$50 penalty.

Hurricane tax relief. Special rules apply to the use of retirement funds (including IRAs) by qualified individuals who suffered an economic loss as a result of Hurricane Katrina, Rita, or Wilma. See *Hurricane-Related Relief* in chapter 4 of Publication 590.



The term "50 or older" is used several times in this chapter. It refers to an IRA owner who is age 50 or older by the end of the tax year.

Introduction

An individual retirement arrangement (IRA) is a personal savings plan that gives you tax advantages for setting aside money for your retirement.

This chapter discusses the following topics.

- The rules for a traditional IRA (any IRA that is not a Roth or SIMPLE IRA).
- The Roth IRA, which features nondeductible contributions and tax-free distributions.

Simplified Employee Pensions (SEPs) and Savings Incentive Match Plans for Employees (SIMPLEs) are not discussed in this chapter. For more information on these plans and employees' SEP IRAs and SIMPLE IRAs that are part of these plans, see Publications 560 and 590.

For information about contributions, deductions, withdrawals, transfers, rollovers, and other transactions for 2007, see Publication 590.

Useful Items

You may want to see:

Publication

- ❑ **560** Retirement Plans for Small Business
- ❑ **590** Individual Retirement Arrangements (IRAs)

Form (and Instructions)

- ❑ **5329** Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts
- ❑ **8606** Nondeductible IRAs

Traditional IRAs

In this chapter the original IRA (sometimes called an ordinary or regular IRA) is referred to as a "traditional IRA." Two advantages of a traditional IRA are:

- You may be able to deduct some or all of your contributions to it, depending on your circumstances, and
- Generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

What Is a Traditional IRA?

A traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA.

Who Can Set Up a Traditional IRA?

You can set up and make contributions to a traditional IRA if:

- You (or, if you file a joint return, your spouse) received taxable compensation during the year, and
- You were not age 70½ by the end of the year.

What is compensation? Generally, compensation is what you earn from working. Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts you receive for providing personal services. The IRS treats as compensation any amount properly shown in box 1 (Wages, tips, other compensation) of Form W-2, Wage and Tax Statement, provided that amount is reduced by any amount properly shown in box 11 (Nonqualified plans).

Scholarship and fellowship payments are compensation for this purpose only if shown in box 1 of Form W-2.

Compensation also includes commissions and taxable alimony and separate maintenance payments.

Self-employment income. If you are self-employed (a sole proprietor or a partner), compensation is the net earnings from your trade or business (provided your personal services are a material income-producing factor) reduced by the total of:

- The deduction for contributions made on your behalf to retirement plans, and
- The deduction allowed for one-half of your self-employment taxes.

Compensation includes earnings from self-employment even if they are not subject to self-employment tax because of your religious beliefs.

Nontaxable combat pay. For IRA purposes, your compensation includes any nontaxable combat pay you receive.

What is not compensation? Compensation does not include any of the following items.

- Earnings and profits from property, such as rental income, interest income, and dividend income.
- Pension or annuity income.
- Deferred compensation received (compensation payments postponed from a past year).
- Income from a partnership for which you do not provide services that are a material income-producing factor.
- Any amounts (other than combat pay) you exclude from income, such as foreign earned income and housing costs.

When and How Can a Traditional IRA Be Set Up?

You can set up a traditional IRA at any time. However, the time for making contributions for any year is limited. See *When Can Contributions Be Made*, later.

You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any IRA must meet Internal Revenue Code requirements.

Kinds of traditional IRAs. Your traditional IRA can be an individual retirement account or annuity. It can be part of either a simplified employee pension (SEP) or an employer or employee association trust account.

How Much Can Be Contributed?

There are limits and other rules that affect the amount that can be contributed to a traditional IRA. These limits and other rules are explained below.

Community property laws. Except as discussed later under *Spousal IRA limit*, each spouse figures his or her limit separately, using his or her own compensation. This is the rule even in states with community property laws.

Brokers' commissions. Brokers' commissions paid in connection with your traditional IRA are subject to the contribution limit.

Trustees' fees. Trustees' administrative fees are not subject to the contribution limit.

Qualified reservist repayments. If you are (or were) a member of a reserve component and you were ordered or called to active duty after September 11, 2001, you may be able to contribute (repay) to an IRA amounts equal to any qualified reservist distributions you received. You can make these repayment contributions even if they would cause your total contributions to the IRA to be more than the general limit on contributions. To be eligible to make these repayment contributions, you must have received a qualified reservist distribution from an IRA or from a section 401(k) or 403(b) plan or similar arrangement.

For more information, see *Qualified reservist repayments under How Much Can Be Contributed* in chapter 1 of Publication 590.



Contributions on your behalf to a traditional IRA reduce your limit for contributions to a Roth IRA. (See Roth IRAs, later.)

General limit. The most that can be contributed to your traditional IRA generally is the smaller of the following amounts.

- \$4,000 (\$5,000 if you are 50 or older in 2006).
- Your taxable compensation (defined earlier) for the year.

This is the most that can be contributed regardless of whether the contributions are to one or more traditional IRAs or whether all or part of the contributions are nondeductible. (See *Nondeductible Contributions*, later.) Qualified reservist repayments do not affect this limit.

Example 1. Betty, who is 34 years old and single, earned \$24,000 in 2006. Her IRA contributions for 2006 are limited to \$4,000.

Example 2. John, an unmarried college student working part time, earned \$3,500 in 2006. His IRA contributions for 2006 are limited to \$3,500, the amount of his compensation.

Spousal IRA limit. If you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following amounts.

1. \$4,000 (\$5,000 if you are 50 or older in 2006).
2. The total compensation includible in the gross income of both you and your spouse for the year, reduced by the following two amounts.
 - a. Your spouse's IRA contribution for the year to a traditional IRA.
 - b. Any contribution for the year to a Roth IRA on behalf of your spouse.

This means that the total combined contributions that can be made for the year to your IRA and your spouse's IRA can be as much as \$8,000 (\$9,000 if only one of you is 50 or older, or \$10,000 if both of you are 50 or older).

When Can Contributions Be Made?

As soon as you set up your traditional IRA, contributions can be made to it through your chosen sponsor (trustee or other administrator). Contributions must be in the form of money (cash, check, or money order). Property cannot be contributed.

Contributions must be made by due date. Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, not including extensions.

Nontaxable combat pay. If you received nontaxable combat pay in 2004 or 2005, and the treatment of the combat pay as compensation means that you can contribute more than you already have, you can make additional contributions to an IRA for 2004 or 2005 by May 28, 2009. The contributions will be treated as having been made on the last day of the year for which they were made. If you have already filed your return for a year for which you make a contribution, you must file Form 1040X, Amended U.S. Individual Income Tax Return.

For more information, see *When Can Contributions Be Made* in chapter 1 of Publication 590.

Age 70½ rule. Contributions cannot be made to your traditional IRA for the year in which you reach age 70½ or for any later year.

You attain age 70½ on the date that is 6 calendar months after the 70th anniversary of your birth. If you were born on June 30, 1936, the 70th anniversary of your birth is June 30, 2006, and you attained age 70½ on December 30, 2006. If you were born on July 1, 1936, the 70th anniversary of your birth was July 1, 2006, and you attained age 70½ on January 1, 2007.

Designating year for which contribution is made. If an amount is contributed to your traditional IRA between January 1 and April 15, you should tell the sponsor which year (the current year or the previous year) the contribution is for. If you do not tell the sponsor which year it is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it).

Filing before a contribution is made. You can file your return claiming a traditional IRA contribution before the contribution is actually made. Generally, the contribution must be made by the due date of your return, not including extensions.

Contributions not required. You do not have to contribute to your traditional IRA for every tax year, even if you can.

How Much Can You Deduct?

Generally, you can deduct the lesser of:

- The contributions to your traditional IRA for the year, or
- The general limit (or the spousal IRA limit, if it applies).

However, if you or your spouse was covered by an employer retirement plan, you may not be able to deduct this amount. See *Limit If Covered by Employer Plan*, later.



You may be eligible to claim a credit for contributions to your traditional IRA. For more information see chapter 37.

Trustees' fees. Trustees' administrative fees that are billed separately and paid in connection with your traditional IRA are not deductible as IRA contributions. However, they may be deductible as a miscellaneous itemized deduction on Schedule A (Form 1040). See chapter 28.

Brokers' commissions. Brokers' commissions are part of your IRA contribution and, as such, are deductible subject to the limits.

Table 17-1. Effect of Modified AGI¹ on Deduction if You Are Covered by Retirement Plan at Work

If you are covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is...	AND your modified AGI is...	THEN you can take...
single or head of household	\$50,000 or less	a full deduction.
	more than \$50,000 but less than \$60,000	a partial deduction.
married filing jointly or qualifying widow(er)	\$60,000 or more	no deduction.
	\$75,000 or less	a full deduction.
married filing separately ²	more than \$75,000 but less than \$85,000	a partial deduction.
	\$85,000 or more	no deduction.
married filing separately ²	less than \$10,000	a partial deduction.
	\$10,000 or more	no deduction.

¹Modified AGI (adjusted gross income). See *Modified adjusted gross income (AGI)*.

²If you did not live with your spouse at any time during the year, your filing status is considered Single for this purpose (therefore, your IRA deduction is determined under the "Single" column).

Full deduction. If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for total contributions to one or more traditional IRAs of up to the lesser of the following amounts.

- \$4,000 (\$5,000 if you are 50 or older in 2006).
- 100% of your compensation.

This limit is reduced by any contributions made to a 501(c)(18) plan on your behalf.

Spousal IRA. In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of the following amounts.

1. \$4,000 (\$5,000 if you are 50 or older in 2006).
2. The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts.

- a. The IRA deduction for the year of the spouse with the greater compensation.
- b. Any designated nondeductible contribution for the year made on behalf of the spouse with the greater compensation.
- c. Any contributions for the year to a Roth IRA on behalf of the spouse with the greater compensation.

This limit is reduced by any contributions to a 501(c)(18) plan on behalf of the spouse with the lesser compensation.

Note. If you were divorced or legally separated (and did not remarry) before the end of the year, you cannot deduct any contributions to your spouse's IRA. After a divorce or legal separation, you can deduct only contributions to your own IRA. Your deductions are subject to the rules for single individuals.

Covered by an employer retirement plan. If you or your spouse was covered by an employer

retirement plan at any time during the year for which contributions were made, your deduction may be further limited. This is discussed later under *Limit If Covered by Employer Plan*. Limits on the amount you can deduct do not affect the amount that can be contributed. See *Nondeductible Contributions*, later.

Are You Covered by an Employer Plan?

The Form W-2 you receive from your employer has a box used to indicate whether you were covered for the year. The "Retirement plan" box should be checked if you were covered.

Reservists and volunteer firefighters should also see *Situations in Which You Are Not Covered*, later.

If you are not certain whether you were covered by your employer's retirement plan, you should ask your employer.

Federal judges. For purposes of the IRA deduction, federal judges are covered by an employer retirement plan.

For Which Year(s) Are You Covered?

Special rules apply to determine the tax years for which you are covered by an employer plan. These rules differ depending on whether the plan is a defined contribution plan or a defined benefit plan.

Tax year. Your tax year is the annual accounting period you use to keep records and report income and expenses on your income tax return. For almost all people, the tax year is the calendar year.

Defined contribution plan. Generally, you are covered by a defined contribution plan for a tax year if amounts are contributed or allocated to your account for the plan year that ends with or within that tax year.

A defined contribution plan is a plan that provides for a separate account for each person covered by the plan. Types of defined contribution plans include profit-sharing plans, stock bonus plans, and money purchase pension plans.

Defined benefit plan. If you are eligible to participate in your employer's defined benefit plan for the plan year that ends within your tax year, you are covered by the plan. This rule applies even if you:

- Declined to participate in the plan,
- Did not make a required contribution, or
- Did not perform the minimum service required to accrue a benefit for the year.

A defined benefit plan is any plan that is not a defined contribution plan. Defined benefit plans include pension plans and annuity plans.

No vested interest. If you accrue a benefit for a plan year, you are covered by that plan even if you have no vested interest in (legal right to) the accrual.

Situations in Which You Are Not Covered

Unless you are covered under another employer plan, you are not covered by an employer plan if you are in one of the situations described below.

Table 17-2. Effect of Modified AGI¹ on Deduction if You Are NOT Covered by Retirement Plan at Work

If you are not covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is...	AND your modified AGI is...	THEN you can take...
single, head of household, or qualifying widow(er)	any amount	a full deduction.
married filing jointly or separately with a spouse who <i>is not</i> covered by a plan at work	any amount	a full deduction.
married filing jointly with a spouse who <i>is</i> covered by a plan at work	\$150,000 or less	a full deduction.
	more than \$150,000 but less than \$160,000	a partial deduction.
	\$160,000 or more	no deduction.
married filing separately with a spouse who <i>is</i> covered by a plan at work ²	less than \$10,000	a partial deduction.
	\$10,000 or more	no deduction.

¹Modified AGI (adjusted gross income). See *Modified adjusted gross income (AGI)*.

²You are entitled to the full deduction if you did not live with your spouse at any time during the year.

Social security or railroad retirement. Coverage under social security or railroad retirement is not coverage under an employer retirement plan.

Benefits from a previous employer's plan. If you receive retirement benefits from a previous employer's plan, you are not covered by that plan.

Reservists. If the only reason you participate in a plan is because you are a member of a reserve unit of the armed forces, you may not be covered by the plan. You are not covered by the plan if both of the following conditions are met.

1. The plan you participate in is established for its employees by:
 - a. The United States,
 - b. A state or political subdivision of a state, or
 - c. An instrumentality of either (a) or (b) above.
2. You did not serve more than 90 days on active duty during the year (not counting duty for training).

Volunteer firefighters. If the only reason you participate in a plan is because you are a volunteer firefighter, you may not be covered by the plan. You are not covered by the plan if both of the following conditions are met.

1. The plan you participate in is established for its employees by:
 - a. The United States,
 - b. A state or political subdivision of a state, or
 - c. An instrumentality of either (a) or (b) above.
2. Your accrued retirement benefits at the beginning of the year will not provide more than \$1,800 per year at retirement.

Limit If Covered by Employer Plan

If either you or your spouse was covered by an employer retirement plan, you may be entitled to

only a partial (reduced) deduction or no deduction at all, depending on your income and your filing status.

Your deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. These amounts vary depending on your filing status.

To determine if your deduction is subject to phaseout, you must determine your modified adjusted gross income (AGI) and your filing status. See *Filing status* and *Modified adjusted gross income (AGI)*, later. Then use Table 17-1 or 17-2 to determine if the phaseout applies.

Social security recipients. Instead of using Table 17-1 or 17-2, use the worksheets in Appendix B of Publication 590 if, for the year, all of the following apply.

- You received social security benefits.
- You received taxable compensation.
- Contributions were made to your traditional IRA.
- You or your spouse was covered by an employer retirement plan.

Use those worksheets to figure your IRA deduction, your nondeductible contribution, and the taxable portion, if any, of your social security benefits.

Deduction phaseout. If you were covered by an employer retirement plan and you did not receive any social security retirement benefits, your IRA deduction may be reduced or eliminated depending on your filing status and modified AGI as shown in Table 17-1.


If your spouse is covered. If you are not covered by an employer retirement plan, but your spouse is, and you did not receive any social security benefits, your IRA deduction may be reduced or eliminated entirely depending on your filing status and modified AGI as shown in Table 17-2.

Filing status. Your filing status depends primarily on your marital status. For this purpose, you need to know if your filing status is single or head of household, married filing jointly or qualifying widow(er), or married filing separately. If

you need more information on filing status, see chapter 2.

Lived apart from spouse. If you did not live with your spouse at any time during the year and you file a separate return, your filing status, for this purpose, is single.

Modified adjusted gross income (AGI). How you figure your modified AGI depends on whether you are filing Form 1040 or Form 1040A. If you made contributions to your IRA for 2006 and received a distribution from your IRA in 2006, see Publication 590.

 *Do not assume that your modified AGI is the same as your compensation. Your modified AGI may include income in addition to your compensation (discussed earlier), such as interest, dividends, and income from IRA distributions.*

Form 1040. If you file Form 1040, refigure the amount on the page 1 "adjusted gross income" line without taking into account any of the following amounts.


- IRA deduction.
- Student loan interest deduction.
- Domestic production activities deduction.
- Foreign earned income exclusion.
- Foreign housing exclusion or deduction.
- Exclusion of qualified savings bond interest shown on Form 8815, Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989 (For Filers With Qualified Higher Education Expenses).
- Exclusion of employer-provided adoption benefits shown on Form 8839, Qualified Adoption Expenses.

This is your modified AGI.

Form 1040A. If you file Form 1040A, refigure the amount on the page 1 "adjusted gross income" line without taking into account any of the following amounts.

- IRA deduction.
- Student loan interest deduction.
- Exclusion of qualified savings bond interest shown on Form 8815.

This is your modified AGI.

 *At the time this publication went to print, Congress was considering legislation that would extend the deduction for tuition and fees that expired at the end of 2005. To find out if this legislation was enacted, and for more details, go to www.irs.gov, click on More Forms and Publications, and then on What's Hot in forms and publications, or see Publication 553. If the deduction for tuition and fees is extended, it is not taken into account when figuring your modified adjusted gross income shown above.*

Both contributions for 2006 and distributions in 2006. If all three of the following apply, any IRA distributions you received in 2006 may be partly tax free and partly taxable.

- You received distributions in 2006 from one or more traditional IRAs.
- You made contributions to a traditional IRA for 2006.
- Some of those contributions may be nondeductible contributions.

Worksheet 17-1. Figuring Your Modified AGI

Keep for Your Records 

Use this worksheet to figure your modified adjusted gross income for traditional IRA purposes.

1. Enter your adjusted gross income (AGI) from Form 1040, line 38, or Form 1040A, line 22	1. _____
2. Enter any traditional IRA deduction from Form 1040, line 32, or Form 1040A, line 17	2. _____
3. Enter any student loan interest deduction from Form 1040, line 33, or Form 1040A, line 18	3. _____
4. Enter any domestic production activities deduction from Form 1040, line 35	4. _____
5. Enter any foreign earned income and/or housing exclusion from Form 2555, line 45, or Form 2555-EZ, line 18,	5. _____
6. Enter any foreign housing deduction from Form 2555, line 50	6. _____
7. Enter any excludable savings bond interest from Form 8815, line 14	7. _____
8. Enter any excluded employer-provided adoption benefits from Form 8839, line 30	8. _____
9. Add lines 1 through 8. This is your Modified AGI for traditional IRA purposes	9. _____

If this is your situation, you must figure the taxable part of the traditional IRA distribution before you can figure your modified AGI. To do this, you can use Worksheet 1-5, Figuring the Taxable Part of Your IRA Distribution, in Publication 590.

If at least one of the above does not apply, figure your modified AGI using Worksheet 17-1 in this chapter.

How to figure your reduced IRA deduction. You can figure your reduced IRA deduction for either Form 1040 or Form 1040A by using the worksheets in chapter 1 of Publication 590. Also, the instructions for Form 1040 and Form 1040A include similar worksheets that you may be able to use instead.

Reporting Deductible Contributions

If you file Form 1040, enter your IRA deduction on line 32 of that form. If you file Form 1040A, enter your IRA deduction on line 17. You cannot deduct IRA contributions on Form 1040EZ.

Nondeductible Contributions

Although your deduction for IRA contributions may be reduced or eliminated, contributions can be made to your IRA up to the general limit or, if it applies, the spousal IRA limit. The difference between your total permitted contributions and your IRA deduction, if any, is your nondeductible contribution.

Example. Mike is 28 years old and single. In 2006, he was covered by a retirement plan at work. His salary was \$57,312. His modified AGI was \$65,000. Mike made a \$4,000 IRA contribution for 2006. Because he was covered by a retirement plan and his modified AGI was over \$60,000, he cannot deduct his \$4,000 IRA contribution. He must designate this contribution as a nondeductible contribution by reporting it on Form 8606, as explained next.

Form 8606. To designate contributions as nondeductible, you must file Form 8606.

You do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can even designate otherwise deductible contributions as nondeductible.

You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

Failure to report nondeductible contributions. If you do not report nondeductible contributions, all of the contributions to your traditional IRA will be treated as deductible. All distributions from your IRA will be taxed unless you can show, with satisfactory evidence, that nondeductible contributions were made.

Penalty for overstatement. If you overstate the amount of nondeductible contributions on your Form 8606 for any tax year, you must pay a penalty of \$100 for each overstatement, unless it was due to reasonable cause.

Penalty for failure to file Form 8606. You will have to pay a \$50 penalty if you do not file a required Form 8606, unless you can prove that the failure was due to reasonable cause.

Tax on earnings on nondeductible contributions. As long as contributions are within the contribution limits, none of the earnings or gains on contributions (deductible or nondeductible)

will be taxed until they are distributed. See *When Can You Withdraw or Use IRA Assets*, later.

Cost basis. You will have a cost basis in your traditional IRA if you made any nondeductible contributions. Your cost basis is the sum of the nondeductible contributions to your IRA minus any withdrawals or distributions of nondeductible contributions.

Inherited IRAs

If you inherit a traditional IRA, you are called a beneficiary. A beneficiary can be any person or entity the owner chooses to receive the benefits of the IRA after he or she dies. Beneficiaries of a traditional IRA must include in their gross income any taxable distributions they receive.

Inherited from spouse. If you inherit a traditional IRA from your spouse, you generally have the following three choices.

1. Treat it as your own IRA by designating yourself as the account owner.
2. Treat it as your own by rolling it over into your traditional IRA, or to the extent it is taxable, into a:
 - a. Qualified employer plan,
 - b. Qualified employee annuity plan (section 403(a) plan),
 - c. Tax-sheltered annuity plan (section 403(b) plan), or
 - d. Deferred compensation plan of a state or local government (section 457 plan).
3. Treat yourself as the beneficiary rather than treating the IRA as your own.

Treating it as your own. You will be considered to have chosen to treat the IRA as your own if:

- Contributions (including rollover contributions) are made to the inherited IRA, or
- You do not take the required minimum distribution for a year as a beneficiary of the IRA.

You will only be considered to have chosen to treat the IRA as your own if:

- You are the sole beneficiary of the IRA, and
- You have an unlimited right to withdraw amounts from it.

However, if you receive a distribution from your deceased spouse's IRA, you can roll that distribution over into your own IRA within the 60-day time limit, as long as the distribution is not a required distribution, even if you are not the sole beneficiary of your deceased spouse's IRA.

Inherited from someone other than spouse. If you inherit a traditional IRA from anyone other than your deceased spouse, you cannot treat the inherited IRA as your own. This means that you cannot make any contributions to the IRA. It also means you cannot roll over any amounts into or out of the inherited IRA. However, you can make a trustee-to-trustee transfer as long as the IRA into which amounts are being moved is set up and maintained in the name of the deceased IRA owner for the benefit of you as beneficiary.

For more information, see the discussion of inherited IRAs under *Rollover From One IRA Into Another*, later.

Can You Move Retirement Plan Assets?

You can transfer, tax free, assets (money or property) from other retirement plans (including traditional IRAs) to a traditional IRA. You can make the following kinds of transfers.

- Transfers from one trustee to another.
- Rollovers.
- Transfers incident to a divorce.

Transfers to Roth IRAs. Under certain conditions, you can move assets from a traditional IRA or from a designated Roth account to a Roth IRA. See *Can You Move Amounts Into a Roth IRA* under *Roth IRAs*, later.

Trustee-to-Trustee Transfer

A transfer of funds in your traditional IRA from one trustee directly to another, either at your request or at the trustee's request, is not a rollover. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers, discussed later under *Rollover From One IRA Into Another*. For information about direct transfers to IRAs from retirement plans other than IRAs, see Publication 590.

Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The contribution to the second retirement plan is called a "rollover contribution."

Note. An amount rolled over tax free from one retirement plan to another is generally includible in income when it is distributed from the second plan.

Kinds of rollovers to a traditional IRA. You can roll over amounts from the following plans into a traditional IRA:

- A traditional IRA,
- An employer's qualified retirement plan for its employees,
- A deferred compensation plan of a state or local government (section 457 plan), or
- A tax-sheltered annuity plan (section 403(b) plan).

Treatment of rollovers. You cannot deduct a rollover contribution, but you must report the rollover distribution on your tax return as discussed later under *Reporting rollovers from IRAs* and under *Reporting rollovers from employer plans*.

Kinds of rollovers from a traditional IRA. You may be able to roll over, tax free, a distribution from your traditional IRA into a qualified plan. These plans include the federal Thrift Savings Fund (for federal employees), deferred compensation plans of state or local governments (section 457 plans), and tax-sheltered annuity plans (section 403(b) plans). The part of the distribution that you can roll over is the part that would otherwise be taxable (includible in your income). Qualified plans may, but are not required to, accept such rollovers.

Time limit for making a rollover contribution. You generally must make the rollover contribution by the 60th day after the day you receive the

distribution from your traditional IRA or your employer's plan.

The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control. For more information, see Publication 590.

Extension of rollover period. If an amount distributed to you from a traditional IRA or a qualified employer retirement plan is a frozen deposit at any time during the 60-day period allowed for a rollover, special rules extend the rollover period. For more information, see Publication 590.

More information. For more information on rollovers, see Publication 590.

Rollover From One IRA Into Another

You can withdraw, tax free, all or part of the assets from one traditional IRA if you reinvest them within 60 days in the same or another traditional IRA. Because this is a rollover, you cannot deduct the amount that you reinvest in an IRA.

Waiting period between rollovers. Generally, if you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover.

The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA.

Example. You have two traditional IRAs, IRA-1 and IRA-2. You make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3). You cannot, within 1 year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA.

However, the rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because you have not, within the last year, rolled over, tax free, any distribution from IRA-2 or made a tax-free rollover into IRA-2.

Exception. There is an exception to the rule that amounts rolled over tax free into an IRA cannot be rolled over tax free again within the 1-year period beginning on the date of the original distribution. The exception applies to a distribution which meets all three of the following requirements.

1. It is made from a failed financial institution by the Federal Deposit Insurance Corporation (FDIC) as receiver for the institution.
2. It was not initiated by either the custodial institution or the depositor.
3. It was made because:
 - a. The custodial institution is insolvent, and
 - b. The receiver is unable to find a buyer for the institution.

Partial rollovers. If you withdraw assets from a traditional IRA, you can roll over part of the withdrawal tax free and keep the rest of it. The

amount you keep will generally be taxable (except for the part that is a return of nondeductible contributions). The amount you keep may be subject to the 10% additional tax on early distributions, discussed later under *What Acts Result in Penalties or Additional Taxes*.

Required distributions. Amounts that must be distributed during a particular year under the required distribution rules (discussed later) are not eligible for rollover treatment.

Inherited IRAs. If you inherit a traditional IRA from your spouse, you generally can roll it over, or you can choose to make the inherited IRA your own. See *Treating it as your own*, earlier.

Not inherited from spouse. If you inherit a traditional IRA from someone other than your spouse, you cannot roll it over or allow it to receive a rollover contribution. You must withdraw the IRA assets within a certain period. For more information, see Publication 590.

Reporting rollovers from IRAs. Report any rollover from one traditional IRA to the same or another traditional IRA on lines 15a and 15b, Form 1040, or lines 11a and 11b, Form 1040A.

Enter the total amount of the distribution on Form 1040, line 15a, or Form 1040A, line 11a. If the total amount on Form 1040, line 15a, or Form 1040A, line 11a, was rolled over, enter zero on Form 1040, line 15b, or Form 1040A, line 11b. If the total distribution was not rolled over, enter the taxable portion of the part that was not rolled over on Form 1040, line 15b, or Form 1040A, line 11b. Put "Rollover" next to Form 1040, line 15b, or Form 1040A, line 11b. See the forms instructions.

If you rolled over the distribution in 2007 or from an IRA into a qualified plan (other than an IRA), attach a statement explaining what you did.

Rollover From Employer's Plan Into an IRA

You can roll over into a traditional IRA all or part of an eligible rollover distribution you receive from your (or your deceased spouse's):

- Employer's qualified pension, profit-sharing or stock bonus plan,
- Annuity plan,
- Tax-sheltered annuity plan (section 403(b) plan), or
- Governmental deferred compensation plan (section 457 plan).

A qualified plan is one that meets the requirements of the Internal Revenue Code.

Eligible rollover distribution. Generally, an eligible rollover distribution is any distribution of all or part of the balance to your credit in a qualified retirement plan except the following.

1. A required minimum distribution (explained later under *When Must You Withdraw IRA Assets? (Required Minimum Distributions)*).
2. Hardship distributions.
3. Any of a series of substantially equal periodic distributions paid at least once a year over:
 - a. Your lifetime or life expectancy,
 - b. The lifetimes or life expectancies of you and your beneficiary, or
 - c. A period of 10 years or more.
4. Corrective distributions of excess contributions or excess deferrals, and any income

allocable to the excess, or of excess annual additions and any allocable gains.

5. A loan treated as a distribution because it does not satisfy certain requirements either when made or later (such as upon default), unless the participant's accrued benefits are reduced (offset) to repay the loan.
6. Dividends on employer securities.
7. The cost of life insurance coverage.

Reporting rollovers from employer plans.

Enter the total distribution (before income tax or other deductions were withheld) on Form 1040, line 16a, or Form 1040A, line 12a. This amount should be shown in box 1 of Form 1099-R. From this amount, subtract any contributions (usually shown in box 5 of Form 1099-R) that were taxable to you when made. From that result, subtract the amount that was rolled over either directly or within 60 days of receiving the distribution. Enter the remaining amount, even if zero, on Form 1040, line 16b, or Form 1040A, line 12b. Also, enter "Rollover" next to Form 1040, line 16b, or Form 1040A, line 12b.

Transfers Incident to Divorce

If an interest in a traditional IRA is transferred from your spouse or former spouse to you by a divorce or separate maintenance decree or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as your IRA. The transfer is tax free. For detailed information, see Publication 590.

Converting From Any Traditional IRA to a Roth IRA

You can convert amounts from a traditional IRA into a Roth IRA if, for the tax year you make the withdrawal from the traditional IRA, both of the following requirements are met.

- Your modified AGI (explained later under *Roth IRAs*) is not more than \$100,000.
- You are not a married individual filing a separate return.

Note. If you did not live with your spouse at any time during the year and you file a separate return, your filing status, for this purpose, is single.

Required distributions. You cannot convert amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you reach age 70½) under the required distribution rules (discussed later).

Inherited IRAs. If you inherited a traditional IRA from someone other than your spouse, you cannot convert it to a Roth IRA.

Income. You must include in your gross income distributions from a traditional IRA that you would have had to include in income if you had not converted them into a Roth IRA. You do not include in gross income any part of a distribution from a traditional IRA that is a return of your basis, as discussed later.

If you must include any amount in your gross income, you may have to increase your withholding or make estimated tax payments. See chapter 4.

Recharacterizations

You may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution. More detailed information is in Publication 590.

How to recharacterize a contribution. To recharacterize a contribution, you generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for your tax return for the year during which the contribution was made, you can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. If you recharacterize your contribution, you must do all three of the following.

- Include in the transfer any net income allocable to the contribution. If there was a loss, the net income you must transfer may be a negative amount.
- Report the recharacterization on your tax return for the year during which the contribution was made.
- Treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

No deduction allowed. You cannot deduct the contribution to the first IRA. Any net income you transfer with the recharacterized contribution is treated as earned in the second IRA.

Required notifications. To recharacterize a contribution, you must notify both the trustee of the first IRA (the one to which the contribution was actually made) and the trustee of the second IRA (the one to which the contribution is being moved) that you have elected to treat the contribution as having been made to the second IRA rather than the first. You must make the notifications by the date of the transfer. Only one notification is required if both IRAs are maintained by the same trustee. The notification(s) must include all of the following information.

- The type and amount of the contribution to the first IRA that is to be recharacterized.
- The date on which the contribution was made to the first IRA and the year for which it was made.
- A direction to the trustee of the first IRA to transfer in a trustee-to-trustee transfer the amount of the contribution and any net income (or loss) allocable to the contribution to the trustee of the second IRA.
- The name of the trustee of the first IRA and the name of the trustee of the second IRA.
- Any additional information needed to make the transfer.

Reporting a recharacterization. If you elect to recharacterize a contribution to one IRA as a contribution to another IRA, you must report the recharacterization on your tax return as directed by Form 8606 and its instructions. You must treat the contribution as having been made to the second IRA.

When Can You Withdraw or Use IRA Assets?

There are rules limiting use of your IRA assets and distributions from it. Violation of the rules generally results in additional taxes in the year of

violation. See *What Acts Result in Penalties or Additional Taxes*, later.

Contributions returned before the due date of return. If you made IRA contributions in 2006, you can withdraw them tax free by the due date of your return. If you have an extension of time to file your return, you can withdraw them tax free by the extended due date. You can do this if, for each contribution you withdraw, both of the following conditions apply.

- You did not take a deduction for the contribution.
- You withdraw any interest or other income earned on the contribution. You can take into account any loss on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income earned on the contribution may be a negative amount.

Note. To calculate the amount you must withdraw, see Publication 590.

Earnings includible in income. You must include in income any earnings on the contributions you withdraw. Include the earnings in income for the year in which you made the contributions, not in the year in which you withdraw them.



Generally, except for any part of a withdrawal that is a return of nondeductible contributions (basis), any withdrawal of your contributions after the due date (or extended due date) of your return will be treated as a taxable distribution. Excess contributions can also be recovered tax free as discussed under What Acts Result in Penalties or Additional Taxes, later.

Early distributions tax. The 10% additional tax on distributions made before you reach age 59½ does not apply to these tax-free withdrawals of your contributions. However, the distribution of interest or other income must be reported on Form 5329 and, unless the distribution qualifies as an exception to the age 59½ rule, it will be subject to this tax.

When Must You Withdraw IRA Assets? (Required Minimum Distributions)

You cannot keep funds in a traditional IRA indefinitely. Eventually they must be distributed. If there are no distributions, or if the distributions are not large enough, you may have to pay a 50% excise tax on the amount not distributed as required. See *Excess Accumulations (Insufficient Distributions)*, later. The requirements for distributing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

Required minimum distribution. The amount that must be distributed each year is referred to as the required minimum distribution.

Required distributions not eligible for rollover. Amounts that must be distributed (required minimum distributions) during a particular year are not eligible for rollover treatment.

IRA owners. If you are the owner of a traditional IRA, you must start receiving distributions from your IRA by April 1 of the year following the year in which you reach age 70½. April 1 of the year following the year in which you reach age

70½ is referred to as the required beginning date.

Distributions by the required beginning date. You must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you do not (or did not) receive that minimum amount in your 70½ year, then you must receive distributions for your 70½ year by April 1 of the next year.

If an IRA owner dies after reaching age 70½, but before April 1 of the next year, no minimum distribution is required because death occurred before the required beginning date.



Even if you begin receiving distributions before you attain age 70½, you must begin calculating and receiving required minimum distributions by your required beginning date.

Distributions after the required beginning date. The required minimum distribution for any year after the year you turn 70½ must be made by December 31 of that later year.

Beneficiaries. If you are the beneficiary of a decedent's traditional IRA, the requirements for distributions from that IRA generally depend on whether the IRA owner died before or after the required beginning date for distributions.

More information. For more information, including how to figure your minimum required distribution each year and how to figure your required distribution if you are a beneficiary of a decedent's IRA, see Publication 590.

Are Distributions Taxable?

In general, distributions from a traditional IRA are taxable in the year you receive them.

Exceptions. Exceptions to distributions from traditional IRAs being taxable in the year you receive them are:

- Rollovers,
- Tax-free withdrawals of contributions, discussed earlier, and
- The return of nondeductible contributions, discussed later under *Distributions Fully or Partly Taxable*.



Although a conversion of a traditional IRA is considered a rollover for Roth IRA purposes, it is not an exception to the rule that distributions from a traditional IRA are taxable in the year you receive them. Conversion distributions are includible in your gross income subject to this rule and the special rules for conversions explained in Publication 590.

Qualified charitable distributions. A qualified charitable distribution (QCD) is a nontaxable distribution made directly by the trustee of your IRA (other than a SEP or SIMPLE IRA) to an organization eligible to receive tax-deductible contributions. You must have been at least age 70½ when the distribution was made. Your total QCDs for the year cannot be more than \$100,000. If you file a joint return, your spouse can also have a QCD of up to \$100,000. However, the amount of the QCD is limited to the amount of the distribution that would otherwise be included in income. If your IRA includes nondeductible contributions, the distribution is first considered to be paid out of otherwise taxable income. For more information see Publication 590.



You cannot claim a charitable contribution deduction for any QCD not included in your income.

Ordinary income. Distributions from traditional IRAs that you include in income are taxed as ordinary income.

No special treatment. In figuring your tax, you cannot use the 10-year tax option or capital gain treatment that applies to lump-sum distributions from qualified employer plans.

Distributions Fully or Partly Taxable

Distributions from your traditional IRA may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

Fully taxable. If only deductible contributions were made to your traditional IRA (or IRAs, if you have more than one), you have no basis in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received. See *Reporting taxable distributions on your return*, later.

Partly taxable. If you made nondeductible contributions to any of your traditional IRAs, you have a cost basis (investment in the contract) equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA.

Only the part of the distribution that represents nondeductible contributions (your cost basis) is tax free. If nondeductible contributions have been made, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, and gains (if there are any). Until all of your basis has been distributed, each distribution is partly nontaxable and partly taxable.

Form 8606. You must complete Form 8606 and attach it to your return if you receive a distribution from a traditional IRA and have ever made nondeductible contributions to any of your traditional IRAs. Using the form, you will figure the nontaxable distributions for 2006 and your total IRA basis for 2006 and earlier years.

Note. If you are required to file Form 8606, but you are not required to file an income tax return, you still must file Form 8606. Send it to the IRS at the time and place you would otherwise file an income tax return.

Distributions reported on Form 1099-R. If you receive a distribution from your traditional IRA, you will receive Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., or a similar statement. IRA distributions are shown in boxes 1 and 2a of Form 1099-R. A number or letter code in box 7 tells you what type of distribution you received from your IRA.

Withholding. Federal income tax is withheld from distributions from traditional IRAs unless you choose not to have tax withheld. See chapter 4.

IRA distributions delivered outside the United States. In general, if you are a U.S. citizen or resident alien and your home address is outside the United States or its possessions, you cannot choose exemption from withholding on distributions from your traditional IRA.

Reporting taxable distributions on your return. Report fully taxable distributions, including early distributions on Form 1040, line 15b, or Form 1040A, line 11b (no entry is required on

Form 1040, line 15a, or Form 1040A, line 11a). If only part of the distribution is taxable, enter the total amount on Form 1040, line 15a, or Form 1040A, line 11a, and the taxable part on Form 1040, line 15b, or Form 1040A, line 11b. You cannot report distributions on Form 1040EZ.

What Acts Result in Penalties or Additional Taxes?

The tax advantages of using traditional IRAs for retirement savings can be offset by additional taxes and penalties if you do not follow the rules.

There are additions to the regular tax for using your IRA funds in prohibited transactions. There are also additional taxes for the following activities.

- Investing in collectibles.
- Making excess contributions.
- Taking early distributions.
- Allowing excess amounts to accumulate (failing to take required distributions).

There are penalties for overstating the amount of nondeductible contributions and for failure to file a Form 8606, if required.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your traditional IRA by you, your beneficiary, or any disqualified person.

Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

The following are examples of prohibited transactions with a traditional IRA.

- Borrowing money from it.
- Selling property to it.
- Receiving unreasonable compensation for managing it.
- Using it as security for a loan.
- Buying property for personal use (present or future) with IRA funds.

Effect on an IRA account. Generally, if you or your beneficiary engages in a prohibited transaction in connection with your traditional IRA account at any time during the year, the account stops being an IRA as of the first day of that year.

Effect on you or your beneficiary. If your account stops being an IRA because you or your beneficiary engaged in a prohibited transaction, the account is treated as distributing all its assets to you at their fair market values on the first day of the year. If the total of those values is more than your basis in the IRA, you will have a taxable gain that is includable in your income. For information on figuring your gain and reporting it in income, see *Are Distributions Taxable*, earlier. The distribution may be subject to additional taxes or penalties.

Taxes on prohibited transactions. If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

More information. For more information on prohibited transactions, see Publication 590.

Investment in Collectibles

If your traditional IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on early distributions, discussed later.

Collectibles. These include:

- Artworks,
- Rugs,
- Antiques,
- Metals,
- Gems,
- Stamps,
- Coins,
- Alcoholic beverages, and
- Certain other tangible personal property.

Exception. Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.

Excess Contributions

Generally, an excess contribution is the amount contributed to your traditional IRA(s) for the year that is more than the smaller of the following amounts.

- The maximum deductible amount for the year. For 2006, this is \$4,000 (\$5,000 if you are 50 or older).
- Your taxable compensation for the year.

Tax on excess contributions. In general, if the excess contributions for a year are not withdrawn by the date your return for the year is due (including extensions), you are subject to a 6% tax. You must pay the 6% tax each year on excess amounts that remain in your traditional IRA at the end of your tax year. The tax cannot be more than 6% of the value of your IRA as of the end of your tax year.

Excess contributions withdrawn by due date of return. You will not have to pay the 6% tax if you withdraw an excess contribution made during a tax year and you also withdraw interest or other income earned on the excess contribution. You must complete your withdrawal by the date your tax return for that year is due, including extensions.

How to treat withdrawn contributions.

Do not include in your gross income an excess contribution that you withdraw from your traditional IRA before your tax return is due if both the following conditions are met.

- No deduction was allowed for the excess contribution.
- You withdraw the interest or other income earned on the excess contribution.

You can take into account any loss on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income you must withdraw may be a negative amount.

How to treat withdrawn interest or other income. You must include in your gross income the interest or other income that was earned on the excess contribution. Report it on your return for the year in which the excess

contribution was made. Your withdrawal of interest or other income may be subject to an additional 10% tax on early distributions, discussed later.

Excess contributions withdrawn after due date of return. In general, you must include all distributions (withdrawals) from your traditional IRA in your gross income. However, if the following conditions are met, you can withdraw excess contributions from your IRA and not include the amount withdrawn in your gross income.

- Total contributions (other than rollover contributions) for 2006 to your IRA were not more than \$4,000 (\$5,000 if you are 50 or older).
- You did not take a deduction for the excess contribution being withdrawn.

The withdrawal can take place at any time, even after the due date, including extensions, for filing your tax return for the year.

Excess contribution deducted in an earlier year. If you deducted an excess contribution in an earlier year for which the total contributions were not more than the maximum deductible amount for that year (\$2,000 for 2001 and earlier years, \$3,000 for 2002 through 2004 (\$3,500 for 2002 through 2004, and \$4,500 for 2005 if you were 50 or older)), you can still remove the excess from your traditional IRA and not include it in your gross income. To do this, file Form 1040X, Amended U.S. Individual Income Tax Return, for that year and do not deduct the excess contribution on the amended return. Generally, you can file an amended return within 3 years after you filed your return, or 2 years from the time the tax was paid, whichever is later.

Excess due to incorrect rollover information. If an excess contribution in your traditional IRA is the result of a rollover and the excess occurred because the information the plan was required to give you was incorrect, you can withdraw the excess contribution. The limits mentioned above are increased by the amount of the excess that is due to the incorrect information. You will have to amend your return for the year in which the excess occurred to correct the reporting of the rollover amounts in that year. Do not include in your gross income the part of the excess contribution caused by the incorrect information.

Early Distributions

You must include early distributions of taxable amounts from your traditional IRA in your gross income. Early distributions are also subject to an additional 10% tax. See the discussion of Form 5329 under *Reporting Additional Taxes*, later, to figure and report the tax.

Early distributions defined. Early distributions generally are amounts distributed from your traditional IRA account or annuity before you are age 59½.

Age 59½ rule. Generally, if you are under age 59½, you must pay a 10% additional tax on the distribution of any assets (money or other property) from your traditional IRA. Distributions before you are age 59½ are called early distributions.

The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount.

Exceptions. There are several exceptions to the age 59½ rule. Even if you receive a

distribution before you are age 59½, you may not have to pay the 10% additional tax if you are in one of the following situations.

- You have unreimbursed medical expenses that are more than 7.5% of your adjusted gross income.
- The distributions are not more than the cost of your medical insurance.
- You are disabled.
- You are the beneficiary of a deceased IRA owner.
- You are receiving distributions in the form of an annuity.
- The distributions are not more than your qualified higher education expenses.
- You use the distributions to buy, build, or rebuild a first home.
- The distribution is due to an IRS levy of the qualified plan.
- The distribution is a qualified reservist distribution.

Most of these exceptions are explained in Publication 590.

Note. Distributions that are timely and properly rolled over, as discussed earlier, are not subject to either regular income tax or the 10% additional tax. Certain withdrawals of excess contributions after the due date of your return are also tax free and therefore not subject to the 10% additional tax. (See *Excess contributions withdrawn after due date of return*, earlier.) This also applies to transfers incident to divorce, as discussed earlier.

Receivership distributions. Early distributions (with or without your consent) from savings institutions placed in receivership are subject to this tax unless one of the exceptions listed earlier applies. This is true even if the distribution is from a receiver that is a state agency.

Additional 10% tax. The additional tax on early distributions is 10% of the amount of the early distribution that you must include in your gross income. This tax is in addition to any regular income tax resulting from including the distribution in income.

Nondeductible contributions. The tax on early distributions does not apply to the part of a distribution that represents a return of your nondeductible contributions (basis).

More information. For more information on early distributions, see Publication 590.

Excess Accumulations (Insufficient Distributions)

You cannot keep amounts in your traditional IRA indefinitely. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age 70½. The required minimum distribution for any year after the year in which you reach age 70½ must be made by December 31 of that later year.

Tax on excess. If distributions are less than the required minimum distribution for the year, you may have to pay a 50% excise tax for that year on the amount not distributed as required.

Request to excuse the tax. If the excess accumulation is due to reasonable error, and you have taken, or are taking, steps to remedy the insufficient distribution, you can request that the tax be excused. If you believe you qualify for this relief, file Form 5329, and attach a letter of explanation.

Exemption from tax. If you are unable to take required distributions because you have a traditional IRA invested in a contract issued by an insurance company that is in state insurer delinquency proceedings, the 50% excise tax does not apply if the conditions and requirements of Revenue Procedure 92-10 are satisfied.

More information. For more information on excess accumulations, see Publication 590.

Reporting Additional Taxes

Generally, you must use Form 5329 to report the tax on excess contributions, early distributions, and excess accumulations. If you must file Form 5329, you cannot use Form 1040A or Form 1040EZ.

Filing a tax return. If you must file an individual income tax return, complete Form 5329 and attach it to your Form 1040. Enter the total amount of additional taxes due on Form 1040, line 60.

Not filing a tax return. If you do not have to file a tax return but do have to pay one of the additional taxes mentioned earlier, file the completed Form 5329 with the IRS at the time and place you would have filed your Form 1040. Be sure to include your address on page 1 and your signature and date on page 2. Enclose, but do not attach, a check or money order payable to the United States Treasury for the tax you owe, as shown on Form 5329. Enter your social security number and "2006 Form 5329" on your check or money order.

Form 5329 not required. You do not have to use Form 5329 if either of the following situations exist.

- Distribution code 1 (early distribution) is correctly shown in box 7 of all Forms 1099-R. If you do not owe any other additional tax on a distribution, multiply the taxable part of the early distribution by 10% and enter the result on Form 1040, line 60. Put "No" to the left of line 60 to indicate that you do not have to file Form 5329. However, if you owe this tax and also owe any other additional tax on a distribution, do not enter this 10% additional tax directly on your Form 1040. You must file Form 5329 to report your additional taxes.
- If you rolled over part or all of a distribution from a qualified retirement plan, the part rolled over is not subject to the tax on early distributions.

Roth IRAs

Regardless of your age, you may be able to establish and make nondeductible contributions to a retirement plan called a Roth IRA.

Contributions not reported. You do not report Roth IRA contributions on your return.

What Is a Roth IRA?

A Roth IRA is an individual retirement plan that, except as explained in this chapter, is subject to the rules that apply to a traditional IRA (defined earlier). It can be either an account or an annuity. Individual retirement accounts and annuities are described in Publication 590.

To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. A deemed IRA can be a Roth IRA, but

neither a SEP IRA nor a SIMPLE IRA can be designated as a Roth IRA.

Unlike a traditional IRA, you cannot deduct contributions to a Roth IRA. But, if you satisfy the requirements, qualified distributions (discussed later) are tax free. Contributions can be made to your Roth IRA after you reach age 70½ and you can leave amounts in your Roth IRA as long as you live.

When Can a Roth IRA Be Set Up?

You can set up a Roth IRA at any time. However, the time for making contributions for any year is limited. See *When Can You Make Contributions*, later under *Can You Contribute to a Roth IRA?*

Can You Contribute to a Roth IRA?

Generally, you can contribute to a Roth IRA if you have taxable compensation (defined later) and your modified AGI (defined later) is less than:

- \$160,000 for married filing jointly or qualifying widow(er),
- \$10,000 for married filing separately and you lived with your spouse at any time during the year, or
- \$110,000 for single, head of household, or married filing separately and you did not live with your spouse at any time during the year.



You may be eligible to claim a credit for contributions to your Roth IRA. For more information, see chapter 37.

Is there an age limit for contributions? Contributions can be made to your Roth IRA regardless of your age.

Can you contribute to a Roth IRA for your spouse? You can contribute to a Roth IRA for your spouse provided the contributions satisfy the spousal IRA limit (discussed in *How Much Can Be Contributed* under *Traditional IRAs*), you file jointly, and your modified AGI is less than \$160,000.

Compensation. Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services. It also includes commissions, self-employment income, nontaxable combat pay, and taxable alimony and separate maintenance payments.

Modified AGI. Your modified AGI for Roth IRA purposes is your adjusted gross income (AGI) as shown on your return modified as follows.

1. Subtract the following:
 - a. Conversion income. This is any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA.
 - b. Minimum required distributions from IRAs (for conversions only).
2. Add the following deductions and exclusions:
 - a. Traditional IRA deduction,
 - b. Student loan interest deduction,
 - c. Foreign earned income exclusion,
 - d. Foreign housing exclusion or deduction,

- e. Exclusion of qualified savings bond interest shown on Form 8815, and
- f. Exclusion of employer-provided adoption benefits shown on Form 8839.
- g. Domestic production activities deduction from Form 1040, line 35.

You can use Worksheet 17-2 to figure your modified AGI.

How Much Can Be Contributed?

The contribution limit for Roth IRAs generally depends on whether contributions are made only to Roth IRAs or to both traditional IRAs and Roth IRAs.

Roth IRAs only. If contributions are made only to Roth IRAs, your contribution limit generally is the lesser of the following amounts.

- \$4,000 (\$5,000 if you are 50 or older in 2006).
- Your taxable compensation.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced, as explained later under *Contribution limit reduced*.

Roth IRAs and traditional IRAs. If contributions are made to both Roth IRAs and traditional IRAs established for your benefit, your contribution limit for Roth IRAs generally is the same as your limit would be if contributions were made

Worksheet 17-2. Modified Adjusted Gross Income for Roth IRA Purposes

Keep for Your Records



Use this worksheet to figure your modified adjusted gross income for Roth IRA purposes.

1. Enter your adjusted gross income from Form 1040, line 38, or Form 1040A, line 22	1.	
2. Enter any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA or a minimum required distribution from an IRA (if figuring MAGI for conversion purposes)	2.	
3. Subtract line 2 from line 1	3.	
4. Enter any traditional IRA deduction from Form 1040, line 32, or Form 1040A, line 17	4.	
5. Enter any student loan interest deduction from Form 1040, line 33, or Form 1040A, line 18	5.	
6. Enter any domestic production activities deduction from Form 1040, line 35	6.	
7. Enter any foreign earned income and/or housing exclusion from Form 2555, line 45, or Form 2555-EZ, line 18	7.	
8. Enter any foreign housing deduction from Form 2555, line 50	8.	
9. Enter any excludable savings bond interest from Form 8815, line 14	9.	
10. Enter any excluded employer-provided adoption benefits from Form 8839, line 30	10.	
11. Add the amounts on lines 3 through 10	11.	
12. Enter:		
• \$160,000 if married filing jointly or qualifying widow(er)		
• \$10,000 if married filing separately and you lived with your spouse at any time during the year		
• \$110,000 for all others	12.	

Is the amount on line 11 more than the amount on line 12?
If yes, then see the Note below.
If no, then the amount on line 11 is your modified AGI for Roth IRA purposes.

Note. If the amount on line 11 is more than the amount on line 12 and you have other income or loss items, such as social security income or passive activity losses, that are subject to AGI-based phaseouts, you can refigure your AGI solely for the purpose of figuring your modified AGI for Roth IRA purposes. When figuring your modified AGI for conversion purposes, refigure your AGI without taking into account any income from conversions or minimum required distributions from IRAs. (If you receive social security benefits, use *Worksheet 1* in *Appendix B* of Publication 590 to refigure your AGI.) Then go to list item (2) under *Modified AGI* or line 3 above in *Worksheet 17-2* to refigure your modified AGI. If you do not have other income or loss items subject to AGI-based phaseouts, your modified AGI for Roth IRA purposes is the amount on line 11.

Caution. At the time this publication went to print, Congress was considering legislation that would extend the deduction for tuition and fees that expired at the end of 2005. To find out if this legislation was extended and for more details, go to www.irs.gov, click on More Forms and Publications, then on What's Hot in forms and publications, or see Publication 553. If the deduction is extended and you claim the deduction, include the amount you deducted in the total on line 11.

only to Roth IRAs, but then reduced by all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

This means that your contribution limit is the lesser of the following amounts.

- \$4,000 (\$5,000 if you are 50 or older in 2006) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.
- Your taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced, as explained next under *Contribution limit reduced*.

Contribution limit reduced. If your modified AGI is above a certain amount, your contribution limit is gradually reduced. Use Table 17-3 to determine if this reduction applies to you.

Figuring the reduction. If the amount you can contribute to your Roth IRA is reduced, see Publication 590 for how to figure the reduction.

When Can You Make Contributions?

You can make contributions to a Roth IRA for a year at any time during the year or by the due date of your return for that year (not including extensions).



You can make contributions for 2006 by the due date (not including extensions) for filing your 2006 tax return.

What If You Contribute Too Much?

A 6% excise tax applies to any excess contribution to a Roth IRA.

Excess contributions. These are the contributions to your Roth IRAs for a year that equal the total of:

1. Amounts contributed for the tax year to your Roth IRAs (other than amounts properly and timely rolled over from a Roth IRA or properly converted from a traditional IRA, as described later) that are more than your contribution limit for the year, plus
2. Any excess contributions for the preceding year, reduced by the total of:
 - a. Any distributions out of your Roth IRAs for the year, plus
 - b. Your contribution limit for the year minus your contributions to all your IRAs for the year.

Withdrawal of excess contributions. For purposes of determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing your tax return for the year is treated as an amount not contributed. This treatment applies only if any earnings on the contributions are also withdrawn. The earnings are considered to have been earned and received in the year the excess contribution was made.

Table 17-3. Effect of Modified AGI on Roth IRA Contribution

This table shows whether your contribution to a Roth IRA is affected by the amount of your modified adjusted gross income (modified AGI).

IF you have taxable compensation and your filing status is...	AND your modified AGI is...	THEN...
married filing jointly, or qualifying widow(er)	less than \$150,000	you can contribute up to \$4,000 (\$5,000 if you are 50 or older in 2006).
	at least \$150,000 but less than \$160,000	the amount you can contribute is reduced as explained under <i>Contribution limit reduced</i> in Publication 590.
	\$160,000 or more	you cannot contribute to a Roth IRA.
married filing separately and you lived with your spouse at any time during the year	zero (-0-)	you can contribute up to \$4,000 (\$5,000 if you are 50 or older in 2006).
	more than zero (-0-) but less than \$10,000	the amount you can contribute is reduced as explained under <i>Contribution limit reduced</i> in Publication 590.
	\$10,000 or more	you cannot contribute to a Roth IRA.
single, head of household, or married filing separately and you did not live with your spouse at any time during the year	less than \$95,000	you can contribute up to \$4,000 (\$5,000 if you are 50 or older in 2006).
	at least \$95,000 but less than \$110,000	the amount you can contribute is reduced as explained under <i>Contribution limit reduced</i> in Publication 590.
	\$110,000 or more	you cannot contribute to a Roth IRA.

Applying excess contributions. If contributions to your Roth IRA for a year were more than the limit, you can apply the excess contribution in one year to a later year if the contributions for that later year are less than the maximum allowed for that year.

Can You Move Amounts Into a Roth IRA?

You may be able to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. You may be able to recharacterize contributions made to one IRA as having been made directly to a different IRA. You can roll amounts over from a designated Roth account or from one Roth IRA to another Roth IRA.

Conversions

You can convert a traditional IRA to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used. Most of the rules for rollovers, described earlier under *Rollover From One IRA Into Another* under *Traditional IRAs*, apply to these rollovers. However, the 1-year waiting period does not apply.

Conversion methods. You can convert amounts from a traditional IRA to a Roth IRA in any of the following ways.

- **Rollover.** You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.
- **Trustee-to-trustee transfer.** You can direct the trustee of the traditional IRA to

transfer an amount from the traditional IRA to the trustee of the Roth IRA.

- **Same trustee transfer.** If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

Same trustee. Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Converting from a SIMPLE IRA. Generally, you can convert an amount in your SIMPLE IRA to a Roth IRA under the same rules explained earlier under *Converting From Any Traditional IRA to a Roth IRA*.

However, you cannot convert any amount distributed from the SIMPLE IRA during the 2-year period beginning on the date you first participated in any SIMPLE IRA plan maintained by your employer.

More information. For more detailed information on conversions, see Publication 590.

Failed Conversions

If, when you converted amounts from a traditional IRA into a Roth IRA, you expected to have modified AGI of less than \$100,000 and a filing status other than married filing separately, but your expectations did not come true, you have made a failed conversion.

Results of failed conversions. If the converted amount (contribution) is not recharacterized (explained earlier), the contribution will be

treated as a regular contribution to the Roth IRA and subject to the following tax consequences.

- A 6% excise tax per year will apply to any excess contribution not withdrawn from the Roth IRA.
- The distributions from the traditional IRA must be included in your gross income.
- The 10% additional tax on early distributions may apply to any distribution.

How to avoid. You must move the amount converted (including all earnings from the date of conversion) into a traditional IRA by the due date (including extensions) for your tax return for the year during which you made the conversion to the Roth IRA. You do not have to include this distribution (withdrawal) in income. See *Recharacterizations*, earlier, for more information.

Rollover From a Roth IRA

You can withdraw, tax free, all or part of the assets from one Roth IRA if you contribute them within 60 days to another Roth IRA. Most of the rules for rollovers, explained earlier under *Rollover From One IRA Into Another* under *Traditional IRAs*, apply to these rollovers.

Are Distributions Taxable?

You do not include in your gross income qualified distributions or distributions that are a return of your regular contributions from your Roth IRA(s). You also do not include distributions from your Roth IRA that you roll over tax free into another Roth IRA. You may have to include part of other distributions in your income. See *Ordering rules for distributions*, later.

Rollover from designated Roth account. A rollover from a designated Roth account can only be made to another designated Roth account or to a Roth IRA.

What are qualified distributions? A qualified distribution is any payment or distribution from your Roth IRA that meets the following requirements.

1. It is made after the 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for your benefit, and
2. The payment or distribution is:
 - a. Made on or after the date you reach age 59½,
 - b. Made because you are disabled,
 - c. Made to a beneficiary or to your estate after your death, or
 - d. To pay up to \$10,000 (lifetime limit) of certain qualified first-time homebuyer amounts. See Publication 590 for more information.

Additional tax on distributions of conversion contributions within 5-year period. If, within the 5-year period starting with the first day of your tax year in which you convert an amount from a traditional IRA to a Roth IRA, you take a distribution from a Roth IRA, you may have to pay the 10% additional tax on early distributions. You generally must pay the 10% additional tax on any amount attributable to the part of the amount converted (the conversion contribution) that you had to include in income. A separate

5-year period applies to each conversion. See *Ordering rules for distributions*, later, to determine the amount, if any, of the distribution that is attributable to the part of the conversion contribution that you had to include in income.

Additional tax on other early distributions. Unless an exception applies, the taxable part of other distributions from your Roth IRA(s) that are not qualified distributions is subject to the 10% additional tax on early distributions. See Publication 590 for more information.

Ordering rules for distributions. If you receive a distribution from your Roth IRA that is not a qualified distribution, part of it may be taxable. There is a set order in which contributions (including conversion contributions) and earnings are considered to be distributed from your Roth IRA. Regular contributions are distributed first. See Publication 590 for more information.

Must you withdraw or use Roth IRA assets? You are not required to take distributions from your Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs.

More information. For more detailed information on Roth IRAs, see Publication 590.

the rules for payments under instruments executed after 1984. If you need the rules for payments under pre-1985 instruments, get and keep a copy of the 2004 version of Publication 504. That was the last year the information on pre-1985 instruments was included in Publication 504.

Use Table 18-1 in this chapter as a guide to determine whether certain payments are considered alimony.

Definitions. The following definitions apply throughout this chapter.

Spouse or former spouse. Unless otherwise stated, the term “spouse” includes former spouse.

Divorce or separation instrument. The term “divorce or separation instrument” means:

1. A decree of divorce or separate maintenance or a written instrument incident to that decree,
2. A written separation agreement, or
3. A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse. This includes a temporary decree, an interlocutory (not final) decree, and a decree of alimony *pendente lite* (while awaiting action on the final decree or agreement).

Useful Items

You may want to see:

Publication

- 504 Divorced or Separated Individuals

18.

Alimony

Introduction

This chapter discusses the rules that apply if you pay or receive alimony. It covers the following topics.

- What payments are alimony.
- What payments are not alimony, such as child support.
- How to deduct alimony you paid.
- How to report alimony you received as income.
- Whether you must recapture the tax benefits of alimony. Recapture means adding back in your income all or part of a deduction you took in a prior year.

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made under a divorce or separation instrument.

Alimony is deductible by the payer and must be included in the spouse's or former spouse's income. Although this chapter is generally written for the payer of the alimony, the recipient can use the information to determine whether an amount received is alimony.

To be alimony, a payment must meet certain requirements. Different requirements generally apply to payments under instruments executed after 1984 and to payments under instruments executed before 1985. This chapter discusses

General Rules

The following rules apply to alimony regardless of when the divorce or separation instrument was executed.

Payments not alimony. Not all payments under a divorce or separation instrument are alimony. Alimony does not include:

1. Child support,
2. Noncash property settlements,
3. Payments that are your spouse's part of community income as explained under *Community Property* in Publication 504,
4. Payments to keep up the payer's property, or
5. Use of property.

Payments to a third party. Cash payments, checks, or money orders, to a third party on behalf of your spouse under the terms of your divorce or separation instrument can be alimony, if they otherwise qualify. These include payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

Life insurance premiums. Alimony includes premiums you must pay under your divorce or separation instrument for insurance on your life to the extent your spouse owns the policy.

Payments for jointly-owned home. If your divorce or separation instrument states that you must pay expenses for a home owned by you

Table 18-1. **Alimony Requirements (Instruments Executed After 1984)**

<p>Payments ARE alimony if <u>all</u> of the following are true:</p> <p>Payments are required by a divorce or separation instrument.</p> <p>Payer and recipient spouse do not file a joint return with each other.</p> <p>Payment is in cash (including checks or money orders).</p> <p>Payment is not designated in the instrument as not alimony.</p> <p>Spouses legally separated under a decree of divorce or separate maintenance are not members of the same household.</p> <p>Payments are not required after death of the recipient spouse.</p> <p>Payment is not treated as child support.</p>	<p>Payments are NOT alimony if <u>any</u> of the following are true:</p> <p>Payments are not required by a divorce or separation instrument.</p> <p>Payer and recipient spouse file a joint return with each other.</p> <p>Payment is:</p> <ul style="list-style-type: none"> • Not in cash, • A noncash property settlement, • Spouse's part of community income, or • To keep up the payer's property. <p>Payment is designated in the instrument as not alimony.</p> <p>Spouses legally separated under a decree of divorce or separate maintenance are members of the same household.</p> <p>Payments are required after death of the recipient spouse.</p> <p>Payment is treated as child support.</p>
<p><i>These payments are deductible by the payer and includible in income by the recipient.</i></p>	<p><i>These payments are neither deductible by the payer nor includible in income by the recipient.</i></p>

and your spouse or former spouse, some of your payments may be alimony.

Mortgage payments. If you must pay all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify as alimony, you can deduct one-half of the total payments as alimony. If you itemize deductions and the home is a qualified home, you can claim half of the interest in figuring your deductible interest. Your spouse must report one-half of the payments as alimony received. If your spouse itemizes deductions and the home is a qualified home, he or she can claim one-half of the interest on the mortgage in figuring deductible interest.

Taxes and insurance. If you must pay all the real estate taxes or insurance on a home held as tenants in common, you can deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each claim one-half of the real estate taxes and none of the home insurance.

If your home is held as tenants by the entirety or joint tenants, none of your payments for taxes or insurance are alimony. But if you itemize deductions, you can claim all of the real estate taxes and none of the home insurance.

Other payments to a third party. If you made other third-party payments, see Publication 504 to see whether any part of the payments qualifies as alimony.

Instruments Executed After 1984

The following rules for alimony apply to payments under divorce or separation instruments executed after 1984.

Exception for instruments executed before 1985. There are two situations where the rules

for instruments executed after 1984 apply to instruments executed before 1985.

1. A divorce or separation instrument executed before 1985 and then modified after 1984 to specify that the after-1984 rules will apply.
2. A temporary divorce or separation instrument executed before 1985 and incorporated into, or adopted by, a final decree executed after 1984 that:
 - a. Changes the amount or period of payment, or
 - b. Adds or deletes any contingency or condition.

For the rules for alimony payments under pre-1985 instruments not meeting these exceptions, see the 2004 revision of Publication 504 on the IRS website at www.irs.gov.

Example 1. In November 1984, you and your former spouse executed a written separation agreement. In February 1985, a decree of divorce was substituted for the written separation agreement. The decree of divorce did not change the terms for the alimony you pay your former spouse. The decree of divorce is treated as executed before 1985. Alimony payments under this decree are not subject to the rules for payments under instruments executed after 1984.

Example 2. Assume the same facts as in Example 1 except that the decree of divorce changed the amount of the alimony. In this example, the decree of divorce is not treated as executed before 1985. The alimony payments are subject to the rules for payments under instruments executed after 1984.

Alimony requirements. A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and all the following requirements are met.

1. The payment is in cash.

2. The instrument does not designate the payment as not alimony.
3. The spouses are not members of the same household at the time the payments are made. This requirement applies only if the spouses are legally separated under a decree of divorce or separate maintenance.
4. There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
5. The payment is not treated as child support.

Each of these requirements is discussed next.

Cash payment requirement. Only cash payments, including checks and money orders, qualify as alimony. The following do not qualify as alimony.

- Transfers of services or property (including a debt instrument of a third party or an annuity contract).
- Execution of a debt instrument by the payor.
- The use of property.

Payments to a third party. Cash payments to a third party under the terms of your divorce or separation instrument can qualify as cash payments to your spouse. See *Payments to a third party* under *General Rules*, earlier.

Also, cash payments made to a third party at the written request of your spouse may qualify as alimony if all the following requirements are met.

1. The payments are in lieu of payments of alimony directly to your spouse.
2. The written request states that both spouses intend the payments to be treated as alimony.
3. You receive the written request from your spouse before you file your return for the year you made the payments.

Payments designated as not alimony. You and your spouse can designate that otherwise qualifying payments are not alimony. You do this by including a provision in your divorce or separation instrument that states the payments are not deductible as alimony by you and are excludable from your spouse's income. For this purpose, any instrument (written statement) signed by both of you that makes this designation and that refers to a previous written separation agreement is treated as a written separation agreement. If you are subject to temporary support orders, the designation must be made in the original or a later temporary support order.

Your spouse can exclude the payments from income only if he or she attaches a copy of the instrument designating them as not alimony to his or her return. The copy must be attached each year the designation applies.

Spouses cannot be members of the same household. Payments to your spouse while you are members of the same household are not alimony if you are legally separated under a decree of divorce or separate maintenance. A home you formerly shared is considered one household, even if you physically separate yourselves in the home.

You are not treated as members of the same household if one of you is preparing to leave the household and does leave no later than 1 month after the date of the payment.

Exception. If you are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement, support decree, or other court order may qualify as alimony even if you are members of the same household when the payment is made.

Liability for payments after death of recipient spouse. If any part of payments you make must continue to be made for any period after your spouse's death, that part of your payments is not alimony, whether made before or after the death. If all of the payments would continue, then none of the payments made before or after the death are alimony.

The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law.

Example. You must pay your former spouse \$10,000 in cash each year for 10 years. Your divorce decree states that the payments will end upon your former spouse's death. You must also pay your former spouse or your former spouse's estate \$20,000 in cash each year for 10 years. The death of your spouse would not terminate these payments under state law.

The \$10,000 annual payments may qualify as alimony. The \$20,000 annual payments that do not end upon your former spouse's death, they are not alimony.

Substitute payments. If you must make any payments in cash or property after your spouse's death as a substitute for continuing otherwise qualifying payments, the otherwise qualifying payments are not alimony. To the extent that your payments begin, accelerate, or increase because of the death of your spouse, otherwise qualifying payments you made may be treated as payments that were not alimony. Whether or not such payments will be treated as not alimony depends on all the facts and circumstances.

Example 1. Under your divorce decree, you must pay your former spouse \$30,000 annually. The payments will stop at the end of 6 years or upon your former spouse's death, if earlier.

Your former spouse has custody of your minor children. The decree provides that if any child is still a minor at your spouse's death, you must pay \$10,000 annually to a trust until the youngest child reaches the age of majority. The trust income and corpus (principal) are to be used for your children's benefit.

These facts indicate that the payments to be made after your former spouse's death are a substitute for \$10,000 of the \$30,000 annual payments. Of each of the \$30,000 annual payments, \$10,000 is not alimony.

Example 2. Under your divorce decree, you must pay your former spouse \$30,000 annually. The payments will stop at the end of 15 years or upon your former spouse's death, if earlier. The decree provides that if your former spouse dies before the end of the 15-year period, you must pay the estate the difference between \$450,000 ($\$30,000 \times 15$) and the total amount paid up to that time. For example, if your spouse dies at the end of the tenth year, you must pay the estate \$150,000 ($\$450,000 - \$300,000$).

These facts indicate that the lump-sum payment to be made after your former spouse's death is a substitute for the full amount of the \$30,000 annual payments. None of the annual payments are alimony. The result would be the

same if the payment required at death were to be discounted by an appropriate interest factor to account for the prepayment.

Child support. A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. The amount of child support may vary over time. Child support payments are not deductible by the payer and are not taxable to the recipient.

Specifically designated as child support. A payment will be treated as specifically designated as child support to the extent that the payment is reduced either:

1. On the happening of a contingency relating to your child, or
2. At a time that can be clearly associated with the contingency.

A payment may be treated as specifically designated as child support even if other separate payments are specifically designated as child support.

Contingency relating to your child. A contingency relates to your child if it depends on any event relating to that child. It does not matter whether the event is certain or likely to occur. Events relating to your child include the child's:

- Becoming employed,
- Dying,
- Leaving the household,
- Leaving school,
- Marrying, or
- Reaching a specified age or income level.

Clearly associated with a contingency. Payments are presumed to be reduced at a time clearly associated with the happening of a contingency relating to your child only in the following situations.

1. The payments are to be reduced not more than 6 months before or after the date the child will reach 18, 21, or local age of majority.
2. The payments are to be reduced on two or more occasions that occur not more than 1 year before or after a different one of your children reaches a certain age from 18 to 24. This certain age must be the same for each child, but need not be a whole number of years.

In all other situations, reductions in payments are not treated as clearly associated with the happening of a contingency relating to your child.

Either you or the IRS can overcome the presumption in the two situations above. This is done by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to your children. For example, if you can show that the period of alimony payments is customary in the local jurisdiction, such as a period equal to one-half of the duration of the marriage, you can overcome the presumption and may be able to treat the amount as alimony.

How To Deduct Alimony Paid

You can deduct alimony you paid, whether or not you itemize deductions on your return. You must file Form 1040. You cannot use Form 1040A or Form 1040EZ.

Enter the amount of alimony you paid on Form 1040, line 31a. In the space provided on line 31b, enter your spouse's social security number.

If you paid alimony to more than one person, enter the social security number of one of the recipients. Show the social security number and amount paid to each other recipient on an attached statement. Enter your total payments on line 31a.



If you do not provide your spouse's social security number, you may have to pay a \$50 penalty and your deduction may be disallowed.

How To Report Alimony Received

Report alimony you received as income on Form 1040, line 11. You cannot use Form 1040A or Form 1040EZ.



You must give the person who paid the alimony your social security number. If you do not, you may have to pay a \$50 penalty.

Recapture Rule

If your alimony payments decrease or terminate during the first 3 calendar years, you may be subject to the recapture rule. If you are subject to this rule, you have to include in income in the third year part of the alimony payments you previously deducted. Your spouse can deduct in the third year part of the alimony payments he or she previously included in income.

The 3-year period starts with the first calendar year you make a payment qualifying as alimony under a decree of divorce or separate maintenance or a written separation agreement. Do not include any time in which payments were being made under temporary support orders. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments that can require a recapture include:

- A change in your divorce or separation instrument,
- A failure to make timely payments,
- A reduction in your ability to provide support, or
- A reduction in your spouse's support needs.

When to apply the recapture rule. You are subject to the recapture rule in the third year if the alimony you pay in the third year decreases by more than \$15,000 from the second year or the alimony you pay in the second and third

years decreases significantly from the alimony you pay in the first year.

When you figure a decrease in alimony, do not include the following amounts.

1. Payments made under a temporary support order.
2. Payments required over a period of at least 3 calendar years that vary because they are a fixed part of your income from a business or property, or from compensation for employment or self-employment.
3. Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payments before the end of the third year.

Figuring the recapture. You can use Worksheet 1 in Publication 504 to figure recaptured alimony.

Including the recapture in income. If you must include a recapture amount in income, show it on Form 1040, line 11 ("Alimony received"). Cross out "received" and enter "recapture." On the dotted line next to the amount, enter your spouse's last name and social security number.

Deducting the recapture. If you can deduct a recapture amount, show it on Form 1040, line 31a ("Alimony paid"). Cross out "paid" and enter "recapture." In the space provided, enter your spouse's social security number.

19.

Education-Related Adjustments

What's New

Educator expense deduction expires. The deduction from AGI for educator expenses has expired. To deduct educator expenses, you must itemize your deductions. See chapter 26.

Tuition and fees deduction expires. You cannot take a deduction for qualified tuition and fees paid in 2006. But you still may be able to take a credit for these expenses. See chapter 35.



At the time this publication went to print, Congress was considering legislation that would reinstate the expired deductions for educator expenses and tuition and fees. To find out if this legislation was enacted, and for more details, go to www.irs.gov, click on More Forms and Publications, and then on What's Hot in forms and publications, or see Publication 553, Highlights of 2006 Tax Changes.

Reminders

Katrina Emergency Tax Relief Act of 2005. This Act provides tax relief for persons affected by Hurricane Katrina. Under the Act, you may be able to claim a student loan interest deduction. See Publication 4492.

Introduction

This chapter discusses the education-related adjustments you can deduct in figuring your adjusted gross income.

This chapter covers the student loan interest deduction.

Useful Items

You may want to see:

Publication

- 970** Tax Benefits for Education

Student Loan Interest Deduction

Generally, personal interest you pay, other than certain mortgage interest, is not deductible. However, if your modified adjusted gross income (MAGI) is less than \$65,000 (\$135,000 if filing a joint return) you may be able to take a deduction for interest paid on a student loan (also known as an education loan) used for higher education. For most taxpayers, MAGI is the adjusted gross income as figured on their federal income tax return before subtracting any deduction for student loan interest. This deduction can reduce the amount of your income subject to tax by up to \$2,500 in 2006. Table 19-1 summarizes the features of the student loan interest deduction.

Table 19-1. **Student Loan Interest Deduction at a Glance**

Do not rely on this table alone. Refer to the text for more details.

Feature	Description
Maximum benefit	You can decrease your income subject to tax by up to \$2,500.
Loan qualifications	Your student loan <ul style="list-style-type: none"> • must have been taken out solely to pay qualified education expenses, and • cannot be from a related person or made under a qualified employer plan.
Student qualifications	The student must be <ul style="list-style-type: none"> • you, your spouse, or your dependent, and • enrolled at least half-time in a degree program.
Time limit on deduction	You can deduct interest paid during the remaining period of your student loan.
Phaseout	The amount of your deduction depends on your income level.

Student Loan Interest Defined

Student loan interest is interest you paid during the year on a qualified student loan. It includes both required and voluntary interest payments.

Qualified Student Loan

This is a loan you took out solely to pay qualified education expenses (defined later) that were:

- For you, your spouse, or a person who was your dependent (defined in chapter 3) when you took out the loan,
- Paid or incurred within a reasonable period of time before or after you took out the loan, and
- For education provided during an academic period for an eligible student.

Loans from the following sources are not qualified student loans.

- A related person.
- A qualified employer plan.

Exceptions. For purposes of the student loan interest deduction, the following are exceptions to the general rules for dependents.

- You can have a dependent even if you are the dependent of another taxpayer.
- An individual can be your dependent even if the individual filed a joint return with a spouse.
- An individual can be your dependent even if the individual had gross income for the year that was equal to or more than the exemption amount for the year (\$3,300 for 2006).

Reasonable period of time. Qualified education expenses are treated as paid or incurred within a reasonable period of time before or after you take out the loan if they are paid with the proceeds of student loans that are part of a federal postsecondary education loan program.

Even if not paid with the proceeds of that type of loan, the expenses are treated as paid or incurred within a reasonable period of time if both of the following requirements are met.

- The expenses relate to a specific academic period, and
- The loan proceeds are disbursed within a period that begins 90 days before the start of that academic period and ends 90 days after the end of that academic period.

If neither of the above situations applies, the reasonable period of time usually is determined based on all the relevant facts and circumstances.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Eligible student. This is a student who was enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

Enrolled at least half-time. A student was enrolled at least half-time if the student was taking at least half the normal full-time work load for his or her course of study.

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard may not be lower than any of those established by the Department of Education under the Higher Education Act of 1965.

Loan from a related person. You cannot deduct interest on a loan you get from a related person. Related persons include:

- Your spouse,
- Your brothers and sisters,
- Your half brothers and half sisters,
- Your ancestors (parents, grandparents, etc.),
- Your lineal descendants (children, grandchildren, etc.), and
- Certain corporations, partnerships, trusts, and exempt organizations.

Loan from a qualified employer plan. You cannot deduct interest on a loan made under a qualified employer plan or under a contract purchased under such a plan.

Qualified Education Expenses

For purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution, including graduate school. They include amounts paid for the following items.

- Tuition and fees.
- Room and board.
- Books, supplies, and equipment.
- Other necessary expenses (such as transportation).

The cost of room and board qualifies only to the extent that it is not more than the greater of:

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student, or
- The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

Certain educational institutions located outside the United States also participate in the U.S. Department of Education's Federal Student Aid (FSA) programs.

For purposes of the student loan interest deduction, an eligible educational institution also includes an institution conducting an internship or residency program leading to a degree or

certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

An educational institution must meet the above criteria only during the academic period(s) for which the student loan was incurred. The deductibility of interest on the loan is not affected by the institution's subsequent loss of eligibility.



The educational institution should be able to tell you if it is an eligible educational institution.

Adjustments to qualified education expenses. You must reduce your qualified education expenses by certain tax-free items (such as the tax-free part of scholarships and fellowships). See chapter 4 of Publication 970 for details.

Include as Interest

In addition to simple interest on the loan, certain loan origination fees, capitalized interest, interest on revolving lines of credit, and interest on refinanced student loans can be student loan interest if all other requirements are met.

Loan origination fee. This is a one-time fee charged by the lender for the use of money, which is treated as interest accrued over the life of the loan. This payment cannot be for property or services provided by the lender, such as commitment fees or processing costs.

Capitalized interest. This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan.

Interest on revolving lines of credit. This interest, which includes interest on credit card debt, is student loan interest if the borrower uses the line of credit (credit card) only to pay qualified education expenses. See *Qualified Education Expenses*, earlier.

Interest on refinanced student loans. This includes interest on both:

- Consolidated loans—loans used to refinance more than one student loan of the same borrower, and
- Collapsed loans—two or more loans of the same borrower that are treated by both the lender and the borrower as one loan.



If you refinance a qualified student loan for more than your original loan and you use the additional amount for any purpose other than qualified education expenses, you cannot deduct any interest paid on the refinanced loan.

Voluntary interest payments. These are payments made on a qualified student loan during a period when interest payments are not required, such as when the borrower has been granted a deferment or the loan has not yet entered repayment status.

Do Not Include as Interest

You cannot claim a student loan interest deduction for any of the following items.

- Interest you paid on a loan if under the terms of the loan, you are not legally obligated to make interest payments.

- Loan origination fees that are payments for property or services provided by the lender, such as commitment fees or processing costs.
- Interest you paid on a loan to the extent payments were made through your participation in the National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") or certain other state loan repayment programs. For more information, see *Student Loan Repayment Assistance* in chapter 5 of Publication 970.

Can You Claim the Deduction

Generally, you can claim the deduction if all four of the following requirements are met.

- Your filing status is any filing status except married filing separately.
- No one else is claiming an exemption for you on his or her tax return.
- You are legally obligated to pay interest on a qualified student loan.
- You paid interest on a qualified student loan.

Interest paid by others. If you are the person legally obligated to make interest payments and someone else makes a payment of interest on your behalf, you are treated as receiving the payments from the other person and, in turn, paying the interest. See chapter 4 of Publication 970 for more information.

No Double Benefit Allowed

You cannot deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law (for example, home mortgage interest).

How Much Can You Deduct

Your student loan interest deduction for 2006 is generally the smaller of:

- \$2,500, or
- The interest you paid in 2006.

The amount determined above is phased out (gradually reduced) if your MAGI is between \$50,000 and \$65,000 (\$105,000 and \$135,000 if you file a joint return). You cannot take a student loan interest deduction if your MAGI is \$65,000 or more (\$135,000 or more if you file a joint return). For details on figuring your MAGI, see chapter 4 of Publication 970.

How Do You Figure the Deduction

Generally, you figure the deduction using the Student Loan Interest Deduction Worksheet in the Form 1040 or Form 1040A instructions. However, if you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from sources within Puerto Rico, you must complete Worksheet 4-1 in chapter 4 of Publication 970.

To help you figure your student loan interest deduction, you should receive Form 1098-E, Student Loan Interest Statement. Generally, an

institution (such as a bank or governmental agency) that received interest payments of \$600 or more during 2006 on one or more qualified student loans must send Form 1098-E (or acceptable substitute) to each borrower by January 31, 2007.

For qualified student loans taken out before September 1, 2004, the institution is required to

include on Form 1098-E only payments of stated interest. Other interest payments, such as certain loan origination fees and capitalized interest, may not appear on the form you receive. However, if you pay qualifying interest that is not included on Form 1098-E, you can also deduct

those amounts. For information on allocating payments between interest and principal, see chapter 4 of Publication 970.

To claim the deduction, enter the allowable amount on line 33 (Form 1040), or line 18 (Form 1040A).