TAXATION OF RETIREMENT PLAN BENEFITS

The purpose of this text is to explore the tax treatment of distributions from qualified retirement plans, whether they were established by the individual or by an employer.

TAX DEDUCTIBLE SAVINGS AND TAX DEFERRED INCOME

Qualified retirement savings plans are savings plans that are encouraged by the tax laws, but which are subject to certain rules in order to be qualified for the tax benefits. Qualified plans give two important tax benefits not available in other types of investments.

- **The money put into the savings plan is pre-tax income**

No income tax is paid on the money deposited in a qualified retirement plan until the money is withdrawn. In essence, both the employee's money and that which would have been paid in taxes to the government are contributed.

- **Earnings of qualified plans are not immediately taxable**

Qualified plans are tax-exempt entities, and the earnings are not subject to taxation. They become taxable, however, when the money in the savings plan is withdrawn. The combined effect of these two tax breaks for qualified plans make them extremely attractive as an alternative to saving after-tax dollars on which any income will be currently taxable. $1,000 invested at 10% before taxes will accumulate to $6,727 in 20 years. If that amount were then distributed and subject to a 35% tax rate, the after-tax amount would be $4,373.

If the same $1,000 of income is first subject to a 35% tax rate, only $650 will be saved. In addition, the after-tax income on the savings would be 6.5% each year instead of 10%. In 20 years, the total contained in the taxable savings account would only be about $2,290 - a major difference!

The result is that the after-tax distribution from a pension plan over 20 years would be nearly twice the after-tax funds generated by a taxable savings program.

Some taxpayers are concerned that tax rates will be higher in future years, but the benefits of the tax deferred savings plan will overcome higher tax rates over time in most cases. The last column in the following chart shows the break-even rate of tax that could be paid on the pension distribution, so the after-tax amount would be exactly equal to the taxable account.

This column illustrates that a person could afford to pay as much as 75% of the accumulated pension assets for taxes after 30 years and still have as much as with a taxable savings plan.

PENSION SAVINGS VS. TAXABLE GROWTH						
Interest %	**10.0%**		**6.5**			
Savings $	**$1,000**		**650**			
Number Years	**Value Pension**	**After Tax Cash-out**	**Amount Taxable**	**Difference**	**Break-Even Tax Rate**	
01	1,100	715	692	23	37.1%	
05	1,611	1,047	891	156	44.7%	
10	2,594	1,686	1,220	466	53.0%	
15	4,177	2,715	1,672	1,044	60.0%	
20	6,727	4,373	2,290	2,083	66.0%	
25	10,835	7,043	3,138	3,905	71.0%	
30	17,448	11,342	4,299	7,043	75.4%	

After 20 years, the investor in a pension plan could pay a tax rate of 66.0% of the $6,727 and be left with $2,290 after taxes - exactly what the after-tax investor would have accumulated in the same period of time (assuming a 35% income tax rate).

Because of the substantial advantages of tax qualified retirement plans, many taxpayers attempt to use such plans for many other forms of savings or to simply defer their taxes. The tax code discourages the use of qualified plans except for very long term retirement savings. The IRS takes the position that tax benefits should be limited for upper income taxpayers. These restrictions are the primary source of the extensive complications surrounding the tax treatment of qualified retirement savings plans.

TYPES OF QUALIFIED PLANS

Our reference to “Qualified Plans” includes the following:

- Corporate employee pension plans
- Defined contribution plans
- Defined benefit plans
- Target benefit plans
- Profit sharing plans
- Employee Stock Ownership Plans (ESOP)
- Employee thrift plans
- Self employed pension/Keogh plans
- Cash or deferred plans [401(k)]
- Simplified employee pension plans
- Tax sheltered annuities
- Individual Retirement Accounts (IRAs)
- Simple Retirement Plans

There is essentially no difference between non-taxable contributions to a qualified savings account by an employer and a deductible plan contribution by a taxpayer. In most types of employer-funded plans, the employer makes a contribution of money to the plan on behalf of

each employee, but that money is not taxable income to the employee. (The employer is permitted to deduct the plan contributions for all employees, subject to certain restrictions). In an IRA or Keogh for a self-employed individual, the taxpayer contributes to a qualified savings plan and deducts the amount on his or her tax return.

In either case, the money put into a qualified savings plan is not subject to income taxes until the money is withdrawn for retirement, disability or because of terminated employment.

If the funds are not withdrawn for retirement income or other special circumstances, there are special tax penalties. After age 70 ½, there is a penalty tax of 50% for failure to make certain minimum annual distributions from pension plan accounts. The focus of this text is to explain the various rules on the taxation of pension distributions.

PENALTY TAX FOR PREMATURE DISTRIBUTIONS

Because the government wants to encourage the use of tax qualified plans to accumulate money for retirement, it has adopted penalties for taking money out of these plans before a taxpayer is of retirement age.

Distributions from qualified plans before age 59 ½ are subject to a 10% non-deductible penalty tax in addition to any income taxes due. The 10% penalty will not apply if the distribution is due to any of the reasons listed below.

The total amount of a distribution from a qualified plan is taxed as ordinary income at the taxpayer's highest rate applicable for the year of distribution unless the distribution occurs due to one of the following exceptions. If the plan distribution qualifies under one of these reasons, a taxpayer can avoid paying taxes on the entire distribution in a single tax year in addition to any other income the taxpayer might have that year. Distributions exempt from the premature distribution penalty tax include:

1. Distributions to a beneficiary or estate of the employee due to death.

2. Distributions due to disability.

3. Distributions due to separation from service with the employer after the age of 54.

4. Distributions qualifying for ten year averaging (for taxpayers born before 1936).

5. Substantially equal periodic payments over the life of the plan participant and/or the life of a spouse or plan beneficiary following separation from service by the plan participant.

6. Dividends or distributions paid concerning certain employee stock ownership plans (ESOPs).

7. Distributions to the extent of a participant's deductible medical expenses. Medical expenses must exceed 7.5% of AGI.

8. Distribution concerning a qualified domestic relations order (QDRO), i.e., divorce.

9. Distribution made to reduce an excess elective deferral or contribution.

The exception for distributions for separation from service after the year the plan owner attains age 54 is not available for distributions from an IRA rollover account.

The IRS has approved three methods for determining what constitutes a "series of substantially equal periodic payments" in the exception discussed in item 5, above. But if the series of payments is later "modified" (other than under acceptable conditions) before the employee reaches age 59 1/2, or if after he reaches age 59 ½, within five years of the date of the first payment, the employee's tax for the year in which the modification occurs is increased by an amount equal to the tax which, but for the exception, would have been imposed, plus interest for the deferral period.

LIFE INCOME PAYMENTS

The normal method of drawing money out of a qualified savings account is to receive an income for the life of the retiree and his or her spouse. This is called an annuity. In order to receive benefits for only the life of the retiree, a spouse must sign a waiver of the right to a joint and survivor income benefit. Upon the death of the taxpayer/retiree, the payments to a surviving spouse are usually reduced by up to 50%. Upon the death of the retiree and his or her spouse, payments cease. Usually, no residual benefits are paid to the estate or heirs after the death of the retiree and his or her spouse.

The taxpayer and spouse may elect to have the payments made as an annuity to only the taxpayer, in order to receive larger annual payments. In most cases, life insurance may be purchased on the taxpayer to provide funds for the surviving spouse in the event of the untimely death of the taxpayer. The annual cost of the life insurance will usually be less than the extra annuity income gained by shifting from a joint and survivor annuity to a single life annuity.

If all contributions to the plan were made by the employer, all benefits will be taxable as received. Payments to a plan through non-taxable payroll deductions, such as a tax-sheltered annuity or a cash or deferred arrangement, are also fully taxable when received. If part of the plan contributions were made by the employee with non-deductible funds, a portion of the benefits will be received on a tax-free basis.

Amounts received after July 1, 1986 and before the annuity starting date are recovered tax-free on a pro-rata basis. The portion of the early annuity recovery is tax-free to the extent that the total after-tax contributions are to the total account balance. For example, if $10,000 is contributed to an annuity contract now worth $100,000, the tax-free share of the total would be 10% (10,000/100,000). If a payment is received of $50,000, 10% ($5,000) would be tax-free and the remaining $45,000 would be taxable.

NON-DEDUCTIBLE CONTRIBUTIONS

A commercial annuity in which the full initial amount is contributed with after-tax dollars is subject to tax on the amount received over the purchase price. In other words, part of each payment received is considered a return of the after-tax investment.

For example, assume at age 65, a taxpayer bought an annuity contract for $54,000 that would pay an income of $500 a month for life. The remaining life expectancy would be 20 years. One would expect to receive $6,000 a year, or a total of $120,000. The portion of each payment that is a return of the investment is 45% (54,000/120,000). The balance is taxable. After receiving $54,000 of tax-free payments, the remaining payments are fully taxable.

If some of the retirement plan benefits are due to contributions by an employee from after-tax income (i.e. non-deductible contributions), the benefits are partly tax-free and partly taxable. Essentially, the part contributed by the employee with non-deductible funds is returned to the employee without tax. The computations are similar to those involving a commercial annuity,

but the “cost” of the contract is the accumulated amount of the after-tax contributions to the plan.

Before July 1, 1986, employees could recover their own non-deductible contributions to an annuity contract on a tax-free basis if the amounts received were less than the non-deductible contributions.

In the case of a lifetime income (annuity) benefit, an estimate must be made of expected total payments to be received over the life expectancy of the retired employee and any joint income beneficiary. The non-deductible contribution by the employee is then divided by this total amount. That portion of each payment is non-taxable.

LUMP SUM DISTRIBUTIONS

Some types of pension/retirement plans do not give the employee much flexibility on the form of payout. The only choice is for the employee to select between a lifetime annuity or to withdraw the entire account balance in cash upon termination, disability or retirement. However, most plans offer greater flexibility. If an employee participates in a retirement plan that allows him or her to draw out the entire savings account upon separation, the tax law gives the following options.

1. One can elect to rollover the entire distribution to an IRA and let the money accumulate without taxes until drawing funds from the account. (Provide the rollover takes place within 60 days of the withdrawal.)

2. One can elect to pay taxes on the entire amount using a special forward averaging computation if a participant in the plan for at least five years before the date of the distribution. (The five-year rule does not apply to post death distributions and was discontinued after 1999).

The special averaging computation for plan distributions for those born before 1936 uses ten year averaging. Basically, the distribution is divided by ten. The tax is then computed on one tenth of the distribution as if the person was a single taxpayer with no other income, deductions or exemptions. The tax computation is based on the 1986 Tax Tables, adjusted to eliminate the zero tax bracket. The single year tax is then multiplied by ten.

For example, if you received a lump sum distribution of $114,400 it would be divided by ten. The 1986 tax on that amount for a single taxpayer would be $1,706. That amount is multiplied by ten and the total tax on the distribution would be $17,060.

Here are a few examples of the ten-year averaging tax on distributions of more than $100,000. The amounts shown are selected because they coincide with the dividing points in the ten-year averaging Tax Table.

Amount	Taxes	Amount	Taxes
114,440	17,060	286,000	61,570
137,100	21,603	343,200	81,018
171,600	29,538	423,000	111,342
228,880	44,410	571,900	173,880

Lump sum distributions of less than $70,000 are subject to even more favorable treatment under the ten-year averaging rules. Half of a distribution of $20,000 or less is tax-free. The tax-free portion on distributions between $20,000 and $70,000 is phased out. The actual tax on a $20,000 lump sum distribution is just $1,110, using ten-year averaging.

Portions of the lump sum distribution may be subject to special treatment if it qualifies as a long term capital gain, as a distribution of an employee's after-tax contributions to the plan or a distribution of employer securities, which are explained below.

The ten-year averaging election is only available to taxpayers born before 1936 and the lump sum distribution must have been paid in a single year. In addition, the distribution must have included all of the employer's qualified plans of a similar type, in which the employee has any funds. Further, the distribution must have been due to:

- The death of the employee
- Separation from service with the employer
- Disability

The lump sum treatment is not available for amounts received from an IRA. In addition, the election is only available one time. A self-employed taxpayer under the age of 59 ½ is only permitted to use the lump sum distribution averaging election due to disability. (Separation from service does not count.)

If the retirement benefit is taken as a lump sum distribution, then a portion equal to the total non-deductible contributions to the plan will be recovered tax-free.

The balance is treated as taxable, but may be eligible for tax deferral through a rollover to an IRA account or for special income tax treatment because of the five or ten year averaging election.

TREATMENT OF DISTRIBUTIONS OF EMPLOYER SECURITIES

In some cases, an employer may distribute securities to an employee as part of a lump sum distribution. The receipt of such employer securities is most likely to occur concerning an employee stock ownership plan (ESOP) or a qualified stock purchase plan. When an employee receives a distribution of stock, bonds or other securities from an employer as part of a distribution from a qualified plan, the income tax on part of the distribution may be deferred until the securities are sold. The amount paid for the securities by the pension trust is the "cost" used by the employee.

This cost is taxed as part of the pension distribution. However, the net unrealized appreciation (market value less cost) on the securities distributed to the employee is not taxable until the securities are sold. At that time, the unrealized appreciation is treated as a long term capital gain. "Unrealized appreciation" means the excess of the current fair market value of the securities over the cost of the securities to the employer trust.

For example, if an employee received a cash distribution of $100,000 and employer securities that originally cost $10,000, the lump sum distribution total would be $110,000. If the securities were actually worth $50,000, he/she would be able to defer the tax on $40,000 of unrealized appreciation until the securities were sold.

Assuming the securities were later sold for $60,000, only $50,000 would be treated as a long term capital gain. The other $10,000 has been taxed as part of the lump sum pension distribution. This rule does not appear to apply if you put appreciated employer securities into a rollover account.

If the securities were acquired through non-deductible employee contributions, the employee may elect to exclude the net unrealized appreciation from current taxable income. The cost of the securities would be treated as a non-taxable distribution of a non-deductible contribution to the plan. When the securities are sold, the total proceeds less the cost of the securities would be treated as a long term capital gain.

However, if the securities were acquired through employer contributions to the qualified plan trust, then the securities must be distributed as part of a lump sum distribution to qualify for this treatment. In that case, the cost of the securities would be treated as part of the lump sum distribution and the unrealized appreciation would be tax deferred. Upon the sale of securities by the employee, the sale price less the amount previously included in the lump sum distribution would be treated as a long term capital gain.

The major benefit of this election is to be able to offset excess capital losses with capital gains from the sale of appreciated employer securities. A second benefit is to defer tax on the gain. However, there is substantial political pressure on Congress to restore more benefits to capital gains, and this may take the form of a lower top tax rate as compared to other income.

NON-TAXABLE ROLLOVER TO AN IRA

Another election is available to taxpayers that receive lump sum distributions from a qualified plan. A rollover to an IRA may be made if the distribution is the result of:

- Separation from service by an employee
- Disability by an employee or self-employed person
- Death, in which case rollover is available to the spouse

The rollover election must be made within 60 days after receiving the lump sum distribution. Partial plan distributions may be rolled over to an IRA if the partial distribution is at least 50% of the total account balance to the credit of the employee. If an election is made to roll over a partial distribution, the lump sum averaging election cannot be used for any other pension funds. The amount rolled over to an IRA must be the full amount of any distributions you receive, less the amount of your non-deductible contributions to the plan. The amounts you contributed to the plan are recovered tax-free and the balance may be rolled over to an IRA.

Upon withdrawal of the funds from the IRA, the total distribution will be fully taxable as ordinary income, and not subject to the special pension averaging election. While a taxpayer who makes a rollover decision may make an amended return in some cases, it is likely to be helpful in only a few special cases.

Generally, withdrawals from an IRA before age 59 ½ are subject to a 10% premature penalty tax although there are now exceptions to this tax as outlined in the 1997 Taxpayer Relief Act. In addition, minimum annual distributions from an IRA must begin after age 70 ½ unless the individual is still employed, in which case he/she will not have to start receiving distribution until retirement.

ESTATE TAX TREATMENT OF DEATH BENEFITS

Prior to 1985, undistributed benefits from qualified plans were excluded from federal estate and gift taxes. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 replaced this unlimited exclusion with a maximum exclusion of $100,000 for taxpayers who died after December 31, 1984. Then the Deficit Reduction Act of 1984 eliminated the $100,000 exclusion.

However, where a decedent began receiving life income payments from a qualified plan before December 31, 1982, those payments were grandfathered and are fully exempt from estate taxes to the extent of any payments made after death, such as survivor benefits. To qualify for this estate tax exclusion, an irrevocable election to designate the form of retirement benefit must have been made before January 1, 1983.

In general, the beneficiary of a deceased taxpayer with the right to undistributed benefits from a qualified plan will "step into the shoes" of the taxpayer. Various special rules apply to limit the tax benefits of using a retirement plan to transfer assets free of both income taxes and estate or gift taxes.

Unrealized appreciation on other types of assets can escape income taxes upon the death of the owner. The full market value of the asset is included in the estate of the taxpayer and is transferred to any heirs at that value. When the property is sold, no income tax is due except to the extent of any unrealized appreciation since the estate tax valuation date.

Qualified pension assets are an exception to this rule. The full value of the qualified plan assets is included in the estate of the taxpayer, and the beneficiary must include the receipt of qualified plan benefits as income.

Beneficiaries other than a surviving spouse may claim an income tax deduction for any federal estate tax attributable to undistributed benefits from a qualified plan. Qualified plan assets left to a surviving spouse will qualify for the unlimited marital deduction and will not be subject to the regular federal estate tax.

A surviving spouse who receives a lump sum distribution from a qualified plan in which the deceased spouse was a participant, may elect to roll over the distribution to an IRA or elect the ten or five year averaging options that would have been available to the taxpayer. Any other beneficiary of undistributed pension benefits is generally permitted to use the lump sum distribution election if it would have been available to the decedent.

The 1986 Tax Reform Act (TRA-86) established a 15% excise tax for "excess" retirement plan assets not distributed at death. This additional tax was repealed, effective with respect to decedents dying after 1996.

MINIMUM REQUIRED DISTRIBUTIONS

While some taxpayers want to take money out of a qualified plan or IRA before retirement age, others with sufficient funds from other sources prefer to leave as much money as possible in an IRA or other qualified plan as long as possible. To deter taxpayers from leaving money in an IRA or qualified plan until death, escaping income taxes, the law allows two options:

1. Qualified plan account holders must receive the account balance by April 1 of the year following the year in which the account holder reaches age 70 ½.

2. Begin making minimum annual distributions beginning in the year after which they reach age 70 ½.

If still employed at age 70 ½, the employee is allowed to defer distributions until retirement. In addition, a pension plan generally will be required to actuarially increase an employee's accrued benefit to take into account the period after age 70 ½ in which the employee was not receiving benefits.

The minimum annual distributions are basically equal to the amount of a lifetime income (annuity) that could be purchased with the assets in the qualified plan or IRA. These distributions are based on the life expectancy of the account holder and any joint beneficiary, such as a spouse.

For example, if the assets in an IRA amounted to $153,000 and if the account holder is a single male age 71, then the minimum distribution is based on the Uniform Lifetime Table factor of 26.5. That would result in a minimum distribution of $5,774. For a male account holder age 79, (factor 19.5) the minimum required distribution would be $7,846.

Where the pension benefits are for a taxpayer and spouse, the minimum distribution can be based on joint and last survivor table life expectancies. The combined life expectancy is effectively extended, reducing the amount of the minimum distribution.

The minimum annual distribution can be recomputed each year based on life expectancy factors at each successive age. The result is that the remaining life expectancy at each succeeding age will be slightly more than the preceding life expectancy minus one year.

For example, a female, single taxpayer age 75 has a life expectancy of 12.1 years, but a female, single taxpayer age 76 has a life expectancy of 11.6 years rather than 11.1 years. By re-computing the minimum required distribution each year, the taxpayer can significantly reduce the amount that has to be withdrawn from the IRA.

The tax law imposes a 50% penalty tax on any distributions less than the required minimum. There is never an economic justification for leaving the money in the plan and choosing to pay the penalty.

The best way to minimize the required distributions is to have a younger account beneficiary and to re-compute the minimum distribution factors each year.

Sources: Tax Facts, National Underwriter – Total Rewards Insurance Agency