Chapter 4: Retirement Issues

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

INTRODUCTION

Individual retirement accounts (IRAs) became available to taxpayers over 30 years ago. Since then, Congress has made many changes in retirement plan rules and created numerous other plan types. Whether taxpayers are in high income tax brackets or have moderate incomes, they are depositing trillions of dollars into accounts for use during retirement years. IRAs alone account for $3.475 trillion of the $12.1 trillion held in retirement accounts. The IRA accounts for over one out of every four retirement dollars. It is estimated that over 40% of taxpayers have an IRA.[1]

Types of IRAs and Their Owners in 2004[2]

IRA Type	Year Created	Congressional Act	Number of U.S. Households with Type of IRA	Percent of U.S. Households with Type of IRA
Traditional IRA	1974	Employee Retirement Income Security Act	36.7 million	32.8%
Roth IRA	1997	Taxpayer Relief Act	14.3 million	12.8%
SEP IRA	1978	Revenue Act		
SAR-SEP IRA	1986	Tax Reform Act	9.6 million	8.6%
SIMPLE IRA	1996	Small Business Job Protection Act		

Sources: Investment Company Institute and U.S. Census Bureau (Fundamentals, "IRA Ownership in 2004," www.ici.org/pdf/fm-v14n1.pdf)

The traditional IRA was born when President Gerald R. Ford signed the Employee Retirement Income Security Act (ERISA) in 1974. The IRA was intended to serve two purposes:

1. It gave individuals, who did not have an employer-provided retirement plan, a vehicle by which they could save for retirement. In order to encourage saving, the contributions made to the IRA were tax deductible if certain rules were met.
2. The IRA was also intended to provide a place where employees, who changed employers or retired, could transfer their employer-sponsored retirement fund money until they were ready to begin withdrawals. These transfers were designated as "rollovers."

1. Investment Company Institute Annual Tracking Survey (2000 through 2004) and U.S. Census Bureau
2. Investment Company Institute. *2005 Investment Company Fact Book, 45th Edition*. Washington, DC: Investment Company Institute, May 2005

Tax professionals have done an excellent job educating clients about the advantages of making retirement contributions as seen by the dollars held in retirement accounts. However, tax professionals may fail to discuss the tax consequences involved when these funds are withdrawn or passed to heirs at death. For many taxpayers, this "family bank" is the single largest asset in their estate.

The following discusses how clients can position themselves for a secure retirement and provide a "tax efficient" transfer of assets to their heirs. This asset transfer is referred to as "depletion order" planning. When assessing the total benefits of depletion order planning, tax professionals must assess and understand:

1. Whether a client should begin receiving social security benefits early or delay benefits while depleting other assets;
2. Benefits of tax deferral provided by an IRA, §401(k), §403(b), §457, defined benefit, or §412(i) plans as well as by annuities and cash-value life insurance;
3. Benefits of tax-free income provided by municipal bonds, Roth IRAs, and cash-value life insurance;
4. How to avoid the risk of depleting assets prematurely;
5. The impact of combined income and estate tax by dying with "too much" money remaining in qualified retirement plans;
6. How to utilize the unified credit when qualified money constitutes the majority of assets in the estate;
7. And finally, for the very wealthy, how to minimize taxes over multiple generations.

In order to provide effective advice and counsel, it is imperative to understand multiple disciplines including financial planning, income tax planning, and estate and gift tax planning.

Before a tax professional can discuss various assets and options with a client, he must be able to describe the assets and their tax consequences. Following are some examples of assets the planner must understand and be able to discuss when advising clients in the area of retirement planning and distribution.

SOURCES OF RETIREMENT INCOME

Income used for retirement may come from a variety of sources. Listed below are typical sources of retirement income.

> **Note.** See pages 397–423 in the *2003 University of Illinois Federal Tax Workbook* for comprehensive information on retirement plans.

INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)

There are numerous types of IRAs. The tax consequence of the IRA varies with the type of account.

Traditional IRA

The traditional IRA allows individuals to defer income for themselves and/or for their spouses on a pre-tax basis. Originally, traditional IRA contributions were limited to the lesser of $1,500, or 15% of compensation. Over the past 30 years these limits have increased, and in 2005 a taxpayer can contribute the lesser of $4,000 plus $500 catch-up contribution, if age 50 or over by the end of 2005, or 100% of compensation. If the taxpayer is eligible for another retirement plan, he must abide by modified adjusted gross income (MAGI) limits which can decrease or eliminate his contribution and deduction. If a single taxpayer is covered by a retirement plan at work, and his MAGI is $50,000 or less, he is eligible for a full IRA deduction. He is limited to a partial deduction if his MAGI is between $50,001 and $60,000. If he is married filing jointly, the IRA deduction is phased out between $70,001 and $80,000. For married taxpayers filing separately, the phaseout is between $1 and $10,000.

Congress also liberalized the limits for spousal contributions. If only one taxpayer is covered by a plan at work, the spouse who has no coverage can deduct the lesser of 100% of compensation or $4,000 plus the $500 catch-up contribution. The phaseout occurs between $150,001 and $160,000, unless they file separately. Then the phaseout occurs between $1 and $10,000.

The disadvantage of a traditional IRA is that the value of the account is included in the taxpayer's estate at death. Unlike some assets, an IRA does not receive a step-up in basis. The IRA is also classified as income in respect of a decedent (IRD) to the beneficiary. Therefore, the estate is taxed, depending on the value of the estate, and the beneficiary also recognizes taxable income from the distributions he receives.

Distributions from a traditional IRA must begin by April 1 of the year following the year the taxpayer turns age 70½. These distributions must be of a required minimum amount. These are referred to as required minimum distributions (RMD). If the IRA owner dies before reaching age 70½, no RMD is required since death occurred before the required beginning date. If the IRA owner began taking distributions before age 70½, he must be sure to take at least the RMD amount when he reaches age 70½.

> **Example 1.** Tracy turns age 70½ on May 1, 2005. She must take her first RMD no later than April 1, 2006. In addition, she must take her 2006 RMD by December 31, 2006. She will report both distributions on her 2006 tax return.

Even if the owner takes more than the RMD in one year, he receives no credit for the excess when calculating the next year's RMD.

The RMD is calculated by using the IRA balance at the close of business on December 31 of the preceding year and dividing it by the applicable distribution period or life expectancy. If additional contributions are made to the IRA during the year, they do not affect the RMD for that year.

> **Example 2.** LeAnn's IRA has a balance of $85,000 on December 31, 2004. Prior to April 1, 2005, she contributes $3,000 to the account as a 2004 contribution. Her RMD is based on the December 31, 2004 account balance.

Roth IRA

There are two principal differences between a traditional IRA and a Roth IRA. The first is that the Roth IRA contribution is not deductible. The second is that the Roth IRA earnings are not taxable if certain conditions are met. In addition:

- Contributions can be made even after the taxpayer reaches age 70½.
- No distributions are required to be made during the taxpayer's life.
- A traditional IRA can be converted into a Roth IRA, but a Roth IRA cannot be converted into a traditional IRA.

The Roth IRA is intended to be a retirement vehicle. Therefore, certain rules must be followed to avoid taxation and penalties on distributions. The Roth IRA first must have been in existence for five years. Then either:

1. The account owner must attain the age of 59½,
2. The account owner must become disabled,
3. The account owner must die, or
4. The distribution must be a qualified first-time homebuyer distribution. This exception has a $10,000 limit.

The value of the Roth IRA is included in the deceased's estate. The proceeds remain tax-free to the beneficiary as long as the five-year rule is met.

Self-Directed IRA

The self-directed IRA is not a specific type of IRA. It may be any of the IRAs discussed, but the IRA has a feature which allows the owner to determine the investments held in the IRA. These investments can include such assets as real estate. There are certain investments that are prohibited in an IRA. These include:

- Works of art,
- Rugs,
- Antiques,
- Metals,
- Gems,
- Stamps,
- Coins (except for specific types),
- Alcoholic beverages, and
- Certain other tangible personal property.

A self-directed IRA account must be established through a qualified custodian.

Stretch IRA

The stretch IRA refers to a technique which allows the taxpayer to "stretch out" the payments to a beneficiary over a number of years — possibly the lifetime of the beneficiary. If the IRA owner dies on or after the RMD date, the beneficiary of the IRA must base his RMD on the longer of his life expectancy or the life expectancy of the deceased.

If the IRA owner dies before being required to take an RMD, the beneficiary bases his RMD on his life expectancy. If there are multiple beneficiaries of the IRA, the RMD is based on the life expectancy of the oldest beneficiary.

IRA owners who wish to stretch the beneficiary payments as long as possible should have multiple IRAs. Therefore, each beneficiary bases his RMD on his life expectancy.

If there is no designated beneficiary for the IRA as of September 30 of the year following the year of death, the deceased's age is used to calculate the RMD. If the IRA beneficiary is not an individual, and death occurred before the required beginning date, the entire account must be distributed by the end of the fifth year following the owner's death.

SIMPLE IRA

The SIMPLE IRA was originated as a part of the Small Business Jobs Protection Act of 1996. A SIMPLE retirement account can be part of a §401(k) plan or a plan using IRAs (SIMPLE IRA).

The SIMPLE plan was devised as a tax-favored retirement plan for small employers and self-employed taxpayers. A SIMPLE plan allows an employee to have the employer reduce his salary in exchange for contributing the reduction to his retirement plan. These contributions must go to a SIMPLE IRA, not the employee's traditional IRA. In addition to the salary reduction contributions, the employer must make either matching contributions or nonelective contributions to the plan.

The SIMPLE plan is advantageous to both the employee and the employer. The employee can make larger contributions to the SIMPLE than he can to a traditional IRA — up to the lesser of $10,000, $12,000 if eligible for catch-up contributions, or 100% of salary. The employer can provide a retirement benefit to the employee without the paperwork required for traditional types of retirement plans.

SIMPLE IRAs are treated the same as a traditional IRA for distribution and estate tax purposes.

EMPLOYMENT-RELATED RETIREMENT PLANS

There are numerous types of retirement plans. The differences between types of plans are related to the way they are funded. All of the following types of plans are included in the deceased's gross estate, do not receive a step-up in basis, and produce taxable distributions to the beneficiary:

1. Simplified Employee Pension (SEP) plans
2. Defined benefit pension plans
3. IRC §412(i) plans

Note. IRC §412(i) plans are relatively new. They are defined benefit plans in which the benefits are fully insured by using the guaranteed interest provided by life insurance or fixed annuities. Although the $170,000 benefit limit remains the same, the IRS allows for a slightly higher deduction with these types of accounts because the contributions can be more easily calculated due to the guaranteed elements provided by the underlying insurance investments. This is opposed to a traditional defined benefit plan where the investment returns can fluctuate with market conditions. These types of plans are favored by older business owners with younger employees who wish to maximize current deductions and want guaranteed interest.

4. IRC §401(k) plans
5. Solo §401(k) or Solo defined-benefit plans
6. IRC §403(b) plans
7. IRC §457 plans

Note. The appendix at the end of this chapter summarizes the various types of retirement plans.

BUSINESS ASSETS

If a retiring taxpayer owns a business as a sole proprietor, he may liquidate the business prior to retirement. The sale of these assets produces various types of income. Consequently, it is important for the taxpayer who wishes to minimize income tax to sell his business assets in the correct sequence and to time the sales properly. These business assets include:

- **Inventory.** Any gain from inventory sold prior to death results in ordinary gain and self-employment income if the owner is still in business. If the inventory is held at death, it is included in the estate and has its basis stepped up to fair market value.
- **Machinery, Equipment, Furniture, and Fixtures.** If these assets are sold prior to death, depreciation must be recaptured as ordinary income. If the asset is held until death, it receives a stepped-up basis since it is included in the gross estate.
- **Building.** Sale of a business building results in IRC §1250 depreciation recapture and capital gains. If the building is held at death, it is included in the estate and receives a stepped-up basis.
- **Land.** If land is sold prior to death, the gain is a capital gain. If the land is included in the estate, the basis is stepped up.
- **Goodwill.** For personal service businesses, such as accounting and tax preparation firms, goodwill can have a substantial value. It is taxed at capital gain rates.

INVESTMENTS

Annuities

Annuities may be a part of a retirement plan and are often used to ensure that the retiree receives payments for his lifetime. If the annuity was purchased with after-tax dollars, a portion of the annuity payment represents return of principal, and the balance is considered gain or interest and is taxed as ordinary income. If the annuity is part of a qualified plan, all distributions are taxed as ordinary income. Regardless of whether the annuity is qualified or nonqualified, it is included in the decedent's gross estate, and unlike other types of investments, annuities do not receive a stepped-up basis at death. If the annuity began making distributions (annuitized), only the present value of all future payments (if any) are subject to estate tax. There are two types of annuities.

Fixed Annuity. A fixed annuity (tax-deferred investment) provides a guaranteed specified crediting rate for a specified period of years (e.g., the annuity will pay 6% each year for eight years). After the specified period, the contract reverts to the current prevailing rate but is not less than a predetermined rate (i.e., 3%). Fixed annuities may be used as a funding vehicle for any of the retirement plans mentioned above. In retirement, they may be converted into either guaranteed income for life, guaranteed income for a specified period of years, or a lump-sum payment. Fixed annuities also provide tax-deferred growth for nondeductible money.

Variable Annuity. A variable annuity provides a variable benefit rather than a fixed or guaranteed benefit. The variable annuity is often criticized as an expensive way to provide equity investing in a retirement account. There are some reasons why an investor may consider this type of investment as a funding vehicle for any of the retirement plans mentioned above. The variable annuity:

1. Provides a guaranteed interest account option,
2. Allows tax-free transfers between fund families,
3. Provides a guaranteed death benefit (typically return of contributions), and
4. May be converted into income in retirement based upon a predetermined guaranteed rate of return, regardless of how the underlying investments performed.

There is a new generation of variable annuities that allow investors to ensure against downside risk associated with equity investments.

> **Note.** The use of annuities is an area that should be reviewed with a qualified investment specialist before a decision is made regarding the use of this type of funding vehicle within a qualified plan.

Annuities as an Investment. Taxpayers may purchase annuities as investments, rather than as a part of their retirement plans. The taxpayer should remember that if the proceeds of the annuity are not distributed prior to death, the beneficiary will treat any gain as IRD and pay income tax at the marginal tax rate. The beneficiary will be able to deduct any estate tax paid, which is attributed to the annuity, as an itemized deduction not subject to the 2% limitation.[3]

Example 3. Bachelor Bill Spendthrift purchased an annuity in 1987 for $20,000. In 1992, he invested another $30,000 in the annuity. Upon Bill's death in 2005, the annuity was worth $188,000. The annuity is valued at $188,000 in Bill's estate, but only has a tax basis of $50,000. Newspaper girl, Henrietta Friendly, inherited the annuity. Assuming the estate tax attributed to the annuity is $20,000, and Henrietta takes a lump sum distribution upon receiving the annuity, she will pay income tax on $138,000. She will also be able to claim a miscellaneous itemized deduction, not subject to the 2% limitation, of $20,000 for the estate tax paid.

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3. Rev. Rul. 2005-30, May 16, 2005, and IRC §691(c)

Example 4. Use the same facts as **Example 3**, except the annuity is bequeathed to Bill's church and Henrietta receives a certificate of deposit valued at $188,000. The estate tax will be the same, but neither the church nor Henrietta will pay any income tax.

Individual Stocks

Stocks represent an ownership interest in a company. Often companies sell ownership "shares" as a means of raising capital. If the company does well, the stock's value tends to go up and the stockholders benefit financially. However, if the company does poorly or fails, the stockholder can lose his investment with little or no recourse. The value of the stock is included in the decedent's gross estate, and the beneficiary receives a stepped-up basis in the stock.

The stock value for estate purposes is the mean value of the stock based on the highest and lowest price of the day.

Example 5. Death occurred on Tuesday, August 1, 2005. The decedent owned 50,000 shares of Satyam Computer Services. The low price for the day was $28.74 and the high price was $30.44. Therefore the mean price was $29.59 or (($30.44 + $28.74) ÷ 2). The decedent's holdings in Satyam are valued at $1,479,500.

If death occurs on a day there is not a market for the stock, the value is computed by using the weighted average of the means between the highest and lowest sales on the nearest trading dates before and after death.

Example 6. Death occurred on Sunday, July 31, 2005. The closest date prior to death is July 29 and the closest date after death is August 1, 2005. Satyam closed on July 29 at $28.58 and had a high of $28.62 and a low of $28.02. The stock closed on August 1 at $28.65 with a high of $28.72 and a low of $28.19. The weighted mean average for the estate valuation is $28.39 per share.

Bonds

Bonds represent a loan to either a company, government, or a municipality. Bonds are issued with a specified interest rate for a specified period of time. Unlike the stockholder, the bondholder does not benefit from growth. However, unlike a stockholder, if the issuer of the bond declares bankruptcy, the bondholder is a creditor and he has some recourse to recover his principal. A change in the financial strength of the bond issuer may affect the value of a bond, as will a change in interest rates. The fair market value (FMV) of the bond at the decedent's death is included in his gross estate and the beneficiary receives a stepped-up basis in the bond.

If there is accrued interest on the bond received by the beneficiary, he is only entitled to an IRD deduction if the accrued interest was included in the decedent's estate.

Municipal Bonds

Municipal bonds represent an obligation of a municipality, state, or local government. The bond money is used to finance specific projects such as building local bridges or a local stadium, park, or sports arena. In order to fund these projects, the municipality issues bonds. It promises to pay a specified level of interest. To encourage participation in these issues, the federal government waives federal taxes on the interest the investor receives. In addition, if the investment is in the state where the investor resides, the interest may also be exempt from state income tax.

Any accrued interest on the tax-free municipal bond is not IRD income to the beneficiary. This is because the interest would have been tax-free to the decedent if he received it during his lifetime. The accrued interest, up to the date of death, is included in the decedent's estate.

Mutual Funds

A mutual fund is an account in which a manager pools the resources of multiple investors in order to strengthen the buying power for an individual who may not have the financial capacity to do so on their own. Typically, a manager is restricted to buying or selling stocks and bonds from a specific sector such as large companies, small companies, international companies or certain government or specialty sectors such as health care, technology or real estate. Because of the improved buying power these types of vehicles offer, they are commonly used as the funding vehicle for retirement plans. Mutual funds allow an investor to adequately diversify his portfolio with a relatively small amount of money. As a result, mutual funds are commonly used in IRAs, 401(k)s, Roth IRAs, profit sharing plans, and defined-benefit plans.

Mutual funds are valued by adding the value of all held stocks and dividing by the number of outstanding shares. This is the value at which the mutual fund trades and is the value used in the gross estate. Beneficiaries of mutual funds receive a stepped-up basis in the funds.

Real Estate

Real estate is included in the decedent's estate and receives a stepped-up basis. If the real estate was owned by a decedent who actively participated in farming, the real estate may be eligible for a reduced valuation. IRC §2032A allows farm real estate to be valued at other than its FMV. The calculation is based on Farm Credit Bank interest rates, real estate taxes, and cash rents of comparable land. There are various restrictions on when this valuation method can be used. There are also restrictions on the heir who inherits the real estate.

PERSONAL ASSETS

Residence

The taxpayer's home is the single largest asset for many taxpayers. The sale of the personal residence is tax-free for most taxpayers. This means the home is a possible source of income in the retirement years. This will be discussed later in the chapter.

Vacation Home

The sale of a second home results in a capital gain. Like the personal residence, if it is held at death, it is included in the final estate and receives a stepped-up basis.

For those retired taxpayers who have financial difficulties, this might be the first choice of an asset to liquidate. They might also sell their personal residence and move into the vacation home. Then, the gain described above would escape taxation and be available for retirement expenses. Because the vacation home becomes their new personal residence, any gain on its sale up to the $250,000/$500,000 limit also escapes taxation if they live in the home for two out of the last five years.

Personal Effects

Personal effects sold by the owner prior to death are typically nontaxable since they typically do not sell at a gain. If held until death, they become part of the estate and receive a stepped-up basis.

COST OF RETIREMENT

Before a taxpayer can plan his retirement, he must estimate how much income is needed to support his lifestyle. This is done by looking at expenses for the past three years and determining which expenses will increase and decrease in retirement. Since the retiree will have more leisure time, the expense for recreational activities might increase, however, job-related expenses should decrease. The following table can be used to help estimate living costs during retirement.

Family Living Estimate

Income Source		Expense	
Interest and dividends	____________	Food	____________
Pension	____________	Clothing	____________
SS benefits	____________	Housing	____________
Rental income	____________	Utilities	____________
Other income	____________	Real estate taxes	____________
		Transportation	____________
		Health care	____________
		Income taxes and FICA	____________
		Life insurance	____________
		Other debt payments	____________
		Other expenses	____________
Total income	____________	**Total expense**	____________
		Overage or shortage	____________

Other expenses may include:

- Travel;
- Hobbies;
- Association dues;
- Entertainment costs;
- Charitable donations;
- Gifts (birthdays, weddings, etc.);
- Homeowners and auto insurance;
- Long-term care insurance;
- Education expenses;
- Lawn care;
- Maid service;
- Pool service;
- Home and appliance repairs;
- Dining out;
- Computer Internet service;
- Phones;
- Cable or satellite;
- Pets (veterinarian, grooming, and food);
- Personal care items such as hair cuts, health clubs, manicures, pedicures, or massages; and
- Incidentals or pocket change items such as newspapers, books, chewing gum, or daytime snacks and coffee.

The list can go on and on. Often these types of items make a big difference when establishing a need for income. It is vitally important that living expense estimates are accurate when establishing the income requirement in retirement.

Observation. When estimating living expenses, the taxpayer should refer to a list of expenses, such as the one above. Often times they omit a substantial amount of expenses from the estimate. Underestimating expenses by as little as $250 per month will have an effect of $45,000 over a 15-year period.

The taxpayer and planner should include an inflation factor in their calculation of the family living estimate. If the estimate shows a shortage, then multiplying the shortage by the taxpayer's life expectancy is an indication of the total asset pool the taxpayer should have available for retirement. While expenses increase due to inflation each year, assets should also increase.

Example 7. Robert has a life expectancy of 25 years. Based on his income projection, his living estimate shows a shortage of $20,000 per year. He must have total assets at the time of retirement of $500,000 earning 4% per year to live without depleting his assets or ($500,000 × 4%). However, if he is willing to deplete his assets, he will only need $312,000 of assets earning 4% per year. The $312,000 is computed using a time value of money formula where the assets and income are depleted by $20,000 per year and total depletion occurs at the end of 25 years. The formula also assumes he will have a 4% per year return on the assets.

RETIREMENT INCOME DISTRIBUTION

While asset accumulation and retirement planning phases are important, the distribution phase is equally important. The distribution phase is the period in which the client and planner analyze what was accumulated, and plan for the most efficient way to fund the client's retirement. There are three primary concerns with distribution planning:

1. Make sure the assets support the client's lifestyle.
2. Create the least amount of estate tax for the taxpayer's estate.
3. Cause the least amount of income tax for the beneficiary.

The estate and income tax consequences of selling the various assets were discussed previously. What has not been discussed is the order of depletion.

SOCIAL SECURITY BENEFITS

The first factor to analyze related to income distribution is to determine when a taxpayer should begin receiving social security retirement benefits. The projected amount of benefits is easily determined by contacting the local Social Security office. The Social Security Administration also mails a benefit projection to each taxpayer periodically. Timing of the retirement benefits is contingent on two factors:

1. Taxability of benefits, and
2. Increase in benefits by delaying payments.

Taxability of Benefits

Depending on the annual income of the social security (SS) recipient, the retirement benefit's taxability can range from zero to 85%. The range is determined by the amount of other income the taxpayer receives. The amount of retirement benefits included in the taxpayer's adjusted gross income (AGI) is computed by adding the AGI (without including SS benefits) plus nontaxable income, and 50% of the SS benefits received. The modified AGI is then reduced by a base amount. The base amount for 2005 is:

	50% Taxable		
Filing Status	**Base Amount**	**Upper Limit**	**85% Taxable**
Single, head of household, and qualifying widow(er)	$25,000	$34,000	>$34,000
Married filing separate and lived apart all of 2005	25,000	34,000	>34,000
Married filing jointly	32,000	44,000	>44,000
Married filing separate and lived together	0	0	>0

Example 8. Erin and Eric Smith received social security benefits of $24,000 in 2005. In addition, they received $16,000 of taxable interest, and $5,000 of nontaxable interest. They file a joint tax return. The amount of SS retirement benefits they will be taxed on is $500. They are just above the threshold amount. The worksheet found in IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits,* is completed here for Erin and Eric. Page 1 of their completed Form 1040 is also shown.

Worksheet 1. **Figuring Your Taxable Benefits**

Keep for your records

Before you begin: Is your filing status *Married filing separately?*

- **No.** Go to line 1 below.
- **Yes.** Did you live apart from your spouse all year?
  - **No.** Go to line 1 below.
  - **Yes. Do the following if you file:**
    - **Form 1040:** Enter "D" to the right of the word "benefits" on line 20a, then go to line 1 below.
    - **Form 1040A:** Enter "D" to the right of the word "benefits" on line 14a, then go to line 1 below.

1.	Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 . . . **1.** 24,000 **Note:** *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*		
2.	Enter one-half of line 1	**2.**	12,000
3.	Enter the total of the amounts from: ***Form 1040:*** Lines 7, 8a, 8b, 9a, 10-14, 15b, 16b, 17-19, and 21 ***Form 1040A:*** Lines 7, 8a, 8b, 9a, 10, 11b, 12b, and 13	**3.**	21,000
4.	***Form 1040 filers:*** Enter the total of any exclusions/adjustments for: • Qualified U.S. savings bond interest (Form 8815, line 14) • Adoption benefits (Form 8839, line 30) • Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico ***Form 1040A filers:*** Enter the total of any exclusions for: • Qualified U.S. savings bond interest (Form 8815, line 14) • Adoption benefits (Form 8839, line 30)	**4.**	
5.	Add lines 2, 3, and 4	**5.**	33,000
6.	***Form 1040 filers:*** Enter the amount from Form 1040, line 35, minus any amounts on Form 1040, lines 26 and 27. ***Form 1040A filers:*** Enter the amount from Form 1040A, line 20, minus any amounts on Form 1040A, lines 18 and 19	**6.**	0
7.	Is the amount on line 6 less than the amount on line 5? **No.** STOP None of your social security benefits are taxable. **Yes.** Subtract line 6 from line 5	**7.**	33,000
8.	If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2004, enter $25,000	**8.**	32,000
	Note: If you are married filing separately and you lived with your spouse at any time in 2004, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17.		
9.	Is the amount on line 8 less than the amount on line 7? **No.** STOP None of your benefits are taxable. Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 14a or 14b. But if you are married filing separately and you lived apart from your spouse for all of 2004, enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b. **Yes.** Subtract line 8 from line 7	**9.**	1,000
10.	Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2004	**10.**	12,000
11.	Subtract line 10 from line 9. If zero or less, enter -0-.	**11.**	0
12.	Enter the **smaller** of line 9 or line 10	**12.**	1,000
13.	Enter one-half of line 12	**13.**	500
14.	Enter the **smaller** of line 2 or line 13	**14.**	500
15.	Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	**15.**	0
16.	Add lines 14 and 15	**16.**	500
17.	Multiply line 1 by 85% (.85)	**17.**	20,400
18.	**Taxable benefits.** Enter the **smaller** of line 16 or line 17	**18.**	500

- Enter the amount from line 1 above on Form 1040, line 20a, or on Form 1040A, line 14a.
- Enter the amount from line 18 above on Form 1040, line 20b, or on Form 1040A, line 14b.

Note: *If you received a lump-sum payment in this year that was for an earlier year, also complete Worksheet 2 or 3 and Worksheet 4 to see whether you can report a lower taxable benefit.*

For Example 8

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2005 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2005, or other tax year beginning , 2005, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial	Last name	Your social security number
Eric	Smith	111 11 1111
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Erin	Smith	222 22 2222
Home address (number and street). If you have a P.O. box, see page 16.	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.		Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 16) ▶ ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☒ **Spouse**

Boxes checked on 6a and 6b: 2

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 18)
			☐
			☐
			☐
			☐

If more than four dependents, see page 18.

No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 18)

Dependents on 6c not entered above

d Total number of exemptions claimed

Add numbers on lines above ▶ 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		
8a	**Taxable** interest. Attach Schedule B if required		16,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b 5,000	
9a	Ordinary dividends. Attach Schedule B if required		
b	Qualified dividends (see page 20)	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)		
11	Alimony received		
12	Business income or (loss). Attach Schedule C or C-EZ		
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		
14	Other gains or (losses). Attach Form 4797		
15a	IRA distributions 15a	b Taxable amount (see page 22)	15b
16a	Pensions and annuities 16a	b Taxable amount (see page 22)	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		
18	Farm income or (loss). Attach Schedule F		
19	Unemployment compensation		
20a	Social security benefits 20a 24,000	b Taxable amount (see page 24)	20b 500
21	Other income. List type and amount (see page 24)		
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		16,500

Adjusted Gross Income

23	Educator expenses (see page 26)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction (see page XX)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction (see page XX)	32	
33	Student loan interest deduction (see page XX)	33	
34	Tuition and fees deduction (see page XX)	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 31a and 32 through 35		36
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		16,500

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Example 9. Use the same facts as **Example 8,** except Eric and Erin sell some old business equipment which results in a $14,000 gain. This increases their taxable SS benefits to $11,100. Therefore, they not only increased their AGI by the $14,000 of additional taxable income, but their taxable SS benefits increased by $10,600. Their completed worksheet and Form 1040 are shown.

Worksheet 1. **Figuring Your Taxable Benefits**

Keep for your records

Before you begin: Is your filing status *Married filing separately?*
No. Go to line 1 below.
Yes. Did you live apart from your spouse all year?
No. Go to line 1 below.
Yes. Do the following if you file:
Form 1040: Enter "D" to the right of the word "benefits" on line 20a, then go to line 1 below.
Form 1040A: Enter "D" to the right of the word "benefits" on line 14a, then go to line 1 below.

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099	**1.** 24,000		
Note: *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*			
2. Enter one-half of line 1		**2.**	12,000
3. Enter the total of the amounts from: *Form 1040:* Lines 7, 8a, 8b, 9a, 10-14, 15b, 16b, 17-19, and 21; *Form 1040A:* Lines 7, 8a, 8b, 9a, 10, 11b, 12b, and 13		**3.**	35,000
4. *Form 1040 filers:* Enter the total of any exclusions/adjustments for: • Qualified U.S. savings bond interest (Form 8815, line 14) • Adoption benefits (Form 8839, line 30) • Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico. *Form 1040A filers:* Enter the total of any exclusions for: • Qualified U.S. savings bond interest (Form 8815, line 14) • Adoption benefits (Form 8839, line 30)		**4.**	
5. Add lines 2, 3, and 4		**5.**	47,000
6. *Form 1040 filers:* Enter the amount from Form 1040, line 35, minus any amounts on Form 1040, lines 26 and 27. *Form 1040A filers:* Enter the amount from Form 1040A, line 20, minus any amounts on Form 1040A, lines 18 and 19		**6.**	0
7. Is the amount on line 6 less than the amount on line 5? **No.** STOP None of your social security benefits are taxable. **Yes.** Subtract line 6 from line 5		**7.**	47,000
8. If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2004, enter $25,000		**8.**	32,000
Note: If you are married filing separately and you lived with your spouse at any time in 2004, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17.			
9. Is the amount on line 8 less than the amount on line 7? **No.** STOP None of your benefits are taxable. Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 14a or 14b. But if you are married filing separately and you lived apart from your spouse for all of 2004, enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b. **Yes.** Subtract line 8 from line 7		**9.**	15,000
10. Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2004		**10.**	12,000
11. Subtract line 10 from line 9. If zero or less, enter -0-		**11.**	3,000
12. Enter the **smaller** of line 9 or line 10		**12.**	12,000
13. Enter one-half of line 12		**13.**	6,000
14. Enter the **smaller** of line 2 or line 13		**14.**	6,000
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-		**15.**	2,550
16. Add lines 14 and 15		**16.**	8,550
17. Multiply line 1 by 85% (.85)		**17.**	20,400
18. **Taxable benefits.** Enter the **smaller** of line 16 or line 17		**18.**	8,550

- Enter the amount from line 1 above on Form 1040, line 20a, or on Form 1040A, line 14a.
- Enter the amount from line 18 above on Form 1040, line 20b, or on Form 1040A, line 14b.

Note: *If you received a lump-sum payment in this year that was for an earlier year, also complete Worksheet 2 or 3 and Worksheet 4 to see whether you can report a lower taxable benefit.*

For Example 9

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Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial: Eric	Last name: Smith		**Your social security number**: 111 11 1111
If a joint return, spouse's first name and initial: Erin	Last name: Smith		**Spouse's social security number**: 222 22 2222
Home address (number and street). If you have a P.O. box, see page 16.		Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.			Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 16) ▶ ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☒ **Spouse**

Boxes checked on 6a and 6b: 2

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 18)
			☐
			☐
			☐
			☐

If more than four dependents, see page 18.

No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 18)

Dependents on 6c not entered above

d Total number of exemptions claimed

Add numbers on lines above ▶ 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		
8a	**Taxable** interest. Attach Schedule B if required		16,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b 5,000	
9a	Ordinary dividends. Attach Schedule B if required		
b	Qualified dividends (see page 20)	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)		
11	Alimony received		
12	Business income or (loss). Attach Schedule C or C-EZ		
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		
14	Other gains or (losses). Attach Form 4797		14,000
15a	IRA distributions 15a	b Taxable amount (see page 22)	15b
16a	Pensions and annuities 16a	b Taxable amount (see page 22)	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		
18	Farm income or (loss). Attach Schedule F		
19	Unemployment compensation		
20a	Social security benefits 20a 24,000	b Taxable amount (see page 24)	20b 8,550
21	Other income. List type and amount (see page 24)		
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		38,550

Adjusted Gross Income

23	Educator expenses (see page 26)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction (see page XX)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction (see page XX)	32	
33	Student loan interest deduction (see page XX)	33	
34	Tuition and fees deduction (see page XX)	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 31a and 32 through 35		
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		38,550

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Examples 8 and 9 show that a small increase in taxable income can cause a substantial increase in AGI because of the potential increase in the taxability of the SS benefits. Therefore, a taxpayer considering applying for SS benefits should analyze his mix of income and determine how much of the benefit will be taxable. In **Example 9**, the taxpayer paid an additional $2,625 of income tax.

Additional tax on social security benefits	$ 958
Additional tax on sale of equipment	1,667
	$2,625

Qualifying for Benefits

Currently, taxpayers qualifying for SS retirement benefits may begin receiving them at age 62. If they wait until full retirement age, they receive increased benefits. Full retirement age increases each year. The following chart shows the age required for full benefits.

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943–1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Some taxpayers may want to delay taking their SS benefits at full retirement age. If they delay taking benefits, they receive additional benefits for each year of postponement until they reach age 70. The rate of increase is illustrated by the following table.

Year of Birth	Yearly Rate of Increase	Monthly Rate of Increase
1930	4.5%	3/8 of 1%
1931–1932	5.0%	5/12 of 1%
1933–1934	5.5%	11/24 of 1%
1935–1936	6.0%	1/2 of 1%
1937–1938	6.5%	13/24 of 1%
1939–1940	7.0%	7/12 of 1%
1941–1942	7.5%	5/8 of 1%
1943 or later	8.0%	2/3 of 1%

Currently, the maximum SS benefit an individual can receive is $1,939 per month or $23,268 per year. Without using any cost-of-living adjustment, this increases by 8% or $1,861 for each year the taxpayer delays retirement. A taxpayer with a substantial IRA account balance may want to consider withdrawing money from the IRA to use as retirement income and delay taking his SS benefits. This gives the taxpayer three different tax advantages:

1. He does not pay income tax on 85% of his SS benefits since he is not receiving benefits.
2. He reduces the size of his taxable estate and reduces future estate taxes.
3. His heirs will pay less income tax because the IRA is depleted and they inherit cash instead of the IRA account. In addition, the income tax paid on the IRA distribution reduces the size of the taxable estate.

The taxpayer must consider that he is foregoing up to $16,346 of revenue each year if he is in the top tax bracket.

Annual SS benefit	$23,268
Taxable portion	85%
Taxable SS benefit	$19,778
Marginal tax rate	35%
Income tax	$ 6,922
Annual SS benefit	$23,268
Income tax	(6,922)
Net income	$16,346

If the taxpayer waits only one year before drawing SS benefits, his annual benefit will increase $1,280. This means he must live for 13 years before he breaks even. The computation is actually more complicated than shown above. Consideration must also be given to the time value of money for foregoing the benefit until a later date. However, this is partially offset by the increased benefit to be received over the remaining life of the taxpayer.

Note. In most cases a taxpayer is better off taking SS benefits as early as possible. See Chapter 10, "Social Security," in the *2002 University of Illinois Income Tax Workbook* for a thorough analysis of social security benefits and planning for retirement.

DEPLETING ASSETS

The next step in the planning process is to determine the order of depletion for the assets. The order varies depending on the taxpayer's asset mix and personal preferences.

BUSINESS ASSETS

If the business is liquidated at retirement, it produces taxable income for the owner. As stated earlier, part of the income may be taxed as capital gain income, while other income may be ordinary. In some situations, part of the income may be taxed as self-employment income. The planner must analyze if it is advantageous to sell the business inventory before applying for SS benefits. Depending on the age of retirement, the sale of the inventory may cause a reduction of the SS benefits in the year of sale.

Sequence and Timing

Because the sale of the machinery and equipment normally results in depreciation recapture taxed as ordinary income, it is not an asset to consider for installment sale. Under the installment sale method, it is possible the taxpayer could owe more income tax on the sale than he received in cash in the year of sale.

Normally, the inventory either sells with the business, or the taxpayer has a "closing-out" sale. The sale proceeds from the inventory sale are reported in the year of sale. To reduce taxes, the taxpayer may wait until the following year to sell his equipment.

Unless the taxpayer needs the money, he should consider leasing the land and buildings so they remain in his estate at the time of his death. Under current law, they receive a step-up in basis. This means the beneficiary has little gain to report as income when the assets are sold. Any gain not reported is taxed at capital gain rates.

If the business is closed, the goodwill has no value. If the business is sold as a going concern, the goodwill value is taxed at capital gain rates.

The taxpayer also must be advised how to invest the after-tax proceeds to meet his retirement cash-flow needs.

PERSONAL RESIDENCE

Many taxpayers find they do not need a large house when they retire. Their children don't live at home and they do not want the upkeep required in a larger home. Therefore, they may decide to sell their personal residence and move to a smaller home. Gain of up to $250,000 for a single taxpayer, and $500,000 for a taxpayer filing jointly, may be excluded from taxable income. The taxpayer must own and occupy the home for two of the last five years.[4]

> **Example 10.** Ike and Tina live in a house in Tulsa which is valued at $400,000. They believe a condominium suits their needs. They found one to purchase for $180,000. They make the sale/purchase and have $190,000 remaining after all costs including moving expenses. If they invest this money at 4% per year, it produces $7,600 annually without depleting the principal. If the investment earns 4% per year and they withdraw $12,000 per year for living expenses, the investment will last for 25 years.
>
> If Ike and Tina stay in their current home, and lack the resources to maintain their lifestyle, they may want to investigate the feasibility of utilizing such techniques as reverse mortgages. Reverse mortgages work best for the homeowner in a high interest rate environment. Another technique to consider is a sale lease-back which tends to favor the homeowner when interest rates are low.

If the personal residence is held at death, it becomes part of the owner's estate and receives a step up in basis. Due to the increase in basis, the beneficiary is only taxed on the gain in value realized from the date of death until the property is sold.

RETIREMENT PLANS

Determining how to handle the retirement accounts may be the hardest part of the retirement analysis. Different plans have different tax consequences. In addition, most plans require minimum distributions beginning at age 70½. Failure to take the minimum distribution results in substantial penalties.

Employer-Sponsored Plans

At the time of retirement, the employee must typically make decisions regarding the company pension plan. These decisions may include:

- Taking a lump-sum distribution and paying income tax,
- Taking a lump-sum distribution and rolling the money into an IRA,
- Annuitizing payments over the life of the employee with a guaranteed number of years, and
- Annuitizing the payments over the joint life of the employee and spouse.

4. IRC §121

In order to decide which payment method is best for the taxpayer, certain questions must be asked. These include:

1. Are you comfortable leaving your retirement money with your former employer or would you prefer to choose the company which holds your retirement funds?
2. Do you expect to be in a higher tax bracket in your retirement years than you are now?
3. Do you want to use this money for something other than retirement? This might include the purchase of a retirement home.
4. Are you more comfortable receiving a guaranteed monthly payment for the rest of your life?
5. Do you want the payments to continue for both your life and the life of your spouse?

Example 11. Charles and Linda are in the top tax bracket of 35%. Linda is ready to retire and her company-provided pension plan has a balance of $130,000. If she takes a lump sum distribution and pays all taxes currently, she has $84,500 to invest in other assets. If she rolls the money into an IRA, she invests the entire $130,000, and pays tax when she begins taking distributions.

If Linda is 61 years old and begins to take payments for her lifetime, she receives a payment of $8,800 per year for the remainder of her life. Because the life expectancy of a male is less than a female, taking the payments over the lives of both will not reduce the payments.

Observation. In most cases, leaving the money in the employer's retirement plan reduces the employee's flexibility in determining how to take distributions.

IRAs Other Than a Roth IRA

Taxpayers are often surprised to find that any money in their IRA account is included in their federal gross estate. Unlike other estate assets, it does not receive a stepped-up basis. Therefore, the heirs must pay income tax when they receive the proceeds. If the beneficiary of the IRA is the spouse, she can treat it as her own IRA. Consequently, she can delay taking payments until age 70½ and the IRA is not taxed in the decedent's estate. Other beneficiaries must either elect a lump-sum taxable distribution or they may choose to "stretch" the proceeds over their own life expectancy. Since this technique does not delay the estate tax liability, it is important to ensure there are enough additional assets in the estate or enough life insurance to pay any estate tax liability.

An IRA or qualified plan may constitute a substantial portion of the total estate. If it is unlikely these assets will be depleted during the taxpayer's lifetime, the tax planner faces a different set of planning challenges. The taxpayer must decide to whom he leaves the asset. He must decide whether he names a surviving spouse as beneficiary, or a child. He must decide if he leaves it in trust or leaves it outright. If he leaves assets to a charity, will the retirement assets go to the charity?

The following beneficiary discussion assumes there are enough additional assets in the estate to pay all transfer costs without withdrawing any of the principal of the qualified asset being transferred. These costs include:

- Federal and state estate taxes,
- Attorney's fees,
- Executor fees,
- Last illness and burial,
- Debts and obligations levied against the estate,
- Unpaid income taxes, and
- Other expenses.

Example 12. Richard has a traditional IRA with a balance of $200,000 at the time of his death. He also has a taxable estate and is in a federal estate tax bracket of 47%. Assuming all estate taxes can be attributed to the IRA, the beneficiary is taxed on $106,000 if he takes a lump-sum distribution.[5] If the beneficiary is in a 35% income tax bracket, his after-tax inheritance is only worth $68,900. This means the IRA was reduced by 65%.

Note. This is the worst-case scenario.

Based on **Example 12,** many taxpayers may want to deplete their IRA accounts prior to their death. They can do this by taking a lump-sum distribution and investing the after-tax proceeds in an asset which can receive a stepped-up basis at death. Taxpayers may wish to leave their IRA account to a qualified charity. The amount of the IRA reduces the gross estate, and since the charity is not a taxpayer, it does not treat the IRA as IRD.

Example 13. Marion has a taxable estate and is in the 45% estate tax bracket. She has an IRA valued at $400,000, and a mutual fund valued at $400,000. She wishes to bequeath $400,000 each to her church and her niece. If she makes her niece the beneficiary of the IRA, the "true" value of the bequest is $143,000 (if her niece is in a 35% tax bracket). Because the church is tax-exempt, it receives the entire $400,000 of mutual funds.

If Marion bequeaths the mutual funds to the niece, the "true" value of the bequest is $220,000 because mutual funds receive a stepped-up basis. If the niece sells the funds immediately after receiving them, she does not recognize any gain.

Spouse as Beneficiary to IRA

If an IRA is bequeathed to a spouse, the spouse can treat the IRA as her own. The spouse is subject to the same minimum distribution rules as the original owner. This means she can make contributions to the IRA and minimum distributions are not required until she reaches age 70½. If the IRA exists at the time of her death, it becomes part of her taxable estate.

Nonspouse as Beneficiary of IRA

If the beneficiary of the IRA is someone other than the spouse, distributions must begin by December 31 of the year after the year of the IRA owner's death. The distribution rules follow those described in the stretch IRA section of this chapter.

Roth IRA

If a taxpayer has a Roth IRA at the time of his death, its value is included in his estate. However, because of the rules regarding Roth IRAs, any distributions are tax free to the recipient if the distributions would have been tax free to the owner. Unlike traditional IRAs, the original owner of the Roth IRA is not subject to minimum distribution rules. However, the **beneficiary of a Roth IRA is subject to the distribution rules.**

It is often said that a Roth IRA is inherited tax-free. Unfortunately, this statement can cause a client to reach a false conclusion. While the inherited Roth IRA may not create income tax for the beneficiary, it is subject to estate tax.

Note. The estate tax applies to all assets owned at the time of death, including a Roth IRA.

5. IRC §691(c)

Estate Tax. Currently, the federal estate tax applies to assets owned at death if the taxable estate is more than $1.5 million for deaths occurring in 2004 and 2005. This threshold amount increases until 2010, when the threshold amount of a taxable estate returns to $1 million. Obviously, Congress can change these amounts at any time. Roth IRAs do not have any special exemption from the estate tax. If a Roth IRA is owned at death and it passes to an heir other than the spouse, it is included in the taxable estate.

Example 14. Michael, a wealthy taxpayer, has $800,000 in his qualified pension plan. He chooses to take a lump-sum distribution and roll the plan into a traditional IRA and then into a Roth IRA. Michael is in a 35% federal income tax bracket and a 5% state tax bracket. He must pay $320,000 in federal and state taxes. Since he paid the tax, his federal estate is reduced by $320,000. Assuming a 45% estate tax bracket, $144,000 of estate tax is saved at death, and the net tax cost of the roll-over is only $176,000.

Now that the money is in a Roth IRA, it accumulates income tax free for either Michael or his heir. Had Michael not rolled over the pension, the benefit would also continue to accumulate, but any distribution would be taxable. If Michael lives to age 80, or 15 years from the time of the rollover, the pension would increase to $1,663,000. Assuming the same income and estate tax brackets, the net inheritance will be $548,790.

If the Roth conversion is made, the Roth balance of $480,000 will grow to $998,000. Because it is a Roth IRA, distributions are income tax free, but the Roth IRA is included in the federal estate. Using the same 45% estate tax rate, the net inheritance will be $548,900.

Income Tax Treatment of Roth IRAs at Death. Roth IRAs are taxed the same after death as they are before death, with three exceptions:

1. The 10% early distribution penalty generally does not apply to post-death distributions.

> **Note.** The penalty can apply to a spouse who elects to treat the Roth IRA as his own Roth IRA.

2. Beneficiaries can withdraw earnings tax-free, even if the beneficiary is under 59½ and the decedent was under 59½, but only if the five-year requirement is satisfied.
3. Beneficiaries may be required to take distributions according to rules described below.

One rule that does not change upon death is that a Roth IRA must exist at least five years before earnings can be withdrawn tax-free. Specifically, all earnings can be withdrawn tax-free beginning on the first day of the fifth taxable year after the year in which the Roth IRA was established. That means January 1, 2006, for Roth IRAs established in 2001.

As a result, a beneficiary may have to pay tax on earnings withdrawn prior to the Roth IRA becoming five years old. This effect can occur if an individual establishes a Roth IRA and dies shortly thereafter.

The tax only applies to earnings that accumulate after the Roth IRA contribution. Normally, this is a small portion of the Roth IRA if the monies are withdrawn a short time after the original owner established the Roth IRA. A beneficiary can avoid this tax by leaving the earnings in the Roth IRA for the required five-year period even if the beneficiary immediately withdraws everything except the earnings.

Example 15. In 2004, Julie establishes a rollover Roth IRA with $100,000. In 2006, she dies and leaves her Roth IRA beneficiary $116,000. Since five years did not lapse, the beneficiary owes income tax (but no penalty) on the $16,000 of earnings. Tax can be avoided if the beneficiary withdraws up to $100,000 (paying no tax or penalty) and leaves the remaining $16,000 of earnings in the Roth IRA until 2009.

Rules for Nonspouse Beneficiaries. If a Roth IRA is inherited from someone other than a spouse, she is not permitted to make contributions to the inherited IRA or combine it with any Roth IRA that she had previously established on her own. In addition, the beneficiary must follow the minimum distribution rules for inherited IRAs.

When a traditional IRA is inherited, the distribution rules depend on whether death occurred before or after the required beginning date for distributions. Since there is no required beginning date for distributions from a Roth IRA, the beneficiary is subject to the rules for death occurring before the required beginning date.

If the beneficiary is someone other than the spouse, distributions must satisfy one of the following rules. The beneficiary must:

1. Receive the entire distribution by December 31 of the fifth year following the year of the owner's death, or

2. Receive the entire distribution over his life, or over a period not extending beyond his life.

Spouse as Beneficiary of a Roth IRA. If a Roth IRA is inherited from a spouse, the spouse can elect to treat it as his own Roth IRA. He can make regular or rollover contributions to the Roth IRA. This assumes he is otherwise eligible to make contributions to a Roth IRA of his own. Furthermore, the required distributions described above do not apply to a Roth IRA if he elects to treat it as his own. The spouse can leave the money in the Roth IRA as long as he wants.

Note. If the spouse elects to treat the Roth IRA he inherits as his own Roth IRA, all the rules apply as if he were the original owner of the Roth IRA. In particular, he may not be able to withdraw earnings tax-free or penalty-free until he reaches age 59½.

Trust as Beneficiary. An issue that has become increasingly frustrating in the area of distribution planning is when the IRA or qualified plan constitutes a substantial portion of the total estate. Many estate plans are based on the use of a by-pass trust. Assets which go into the by-pass trust escape estate taxation at the death of the spouse. Therefore, for deaths in 2005, the by-pass trust is funded with $1.5 million of assets.

Example 16. Travis has $1 million in his IRA, with his wife as beneficiary. He also has $1 million of stocks and bonds in his own name. Travis wishes to have his wife receive his IRA. Only $1 million of other assets are available for the by-pass trust. Hence, he has wasted the estate tax savings on $.5 million of assets at the time of his spouse's death. This could potentially cost the next generation between $200,000 and $250,000 of unnecessary estate taxes.

If Travis names his by-pass trust as beneficiary, with his daughter as remainderman, he has created a "stretch IRA" payable to a look-through trust.[6] The required distributions are based on the ages of the beneficiaries of the trust. This causes a situation where the entire balance must be distributed over the oldest beneficiary's life expectancy.

This problem can be partially solved by naming a special by-pass trust as the beneficiary of the IRA. By including a provision in the trust that requires that all retirement plan distributions be payable to the surviving spouse, the surviving spouse is permitted to be treated as the sole beneficiary. This allows her life expectancy to be recalculated every year as opposed to being frozen for a fixed period, as it would be if the trust attempted to utilize the "stretch" IRA approach.[7]

Observation. As IRA balances continue to grow and become an even larger percentage of the deceased's estate, some planners are now specializing in distribution planning for wealthy taxpayers. Many of their solutions are too complex to include here. In addition, many are tailored for a specific taxpayer.

6. Treas. Reg. §1.401(a)(9)-5

7. Ibid

RETIREMENT PLANNING USING INSURANCE

By using insurance products, the planner has some creative options available to offer his clients. While these solutions are not for everyone, they might be a solution for select taxpayers.

The following discussion examines two very different situations. In one scenario, the objective is to maximize disposable income for a couple entering retirement with a relatively modest amount of retirement savings accumulated. The second scenario examines a situation where there is a high likelihood that the older generation will not outlive their assets, thus creating a need for some additional estate planning or "family bank" planning.

Example 17. Joe and Mary Normal have accumulated the following assets and are now both age 65 and eager to retire. Their assets consist of:

Asset	Value	Comments
Traditional IRA	$120,000	Invested in CDs
Employer-provided retirement funds	400,000	50% stock and 50% mutual bond fund
Personal residence	250,000	No mortgage
Personal possessions	50,000	No debts
Cash and other investments	20,000	$10,000 cash and $10,000 Walgreen stock
Total	$840,000	

The tax planner is faced with the following questions:

1. What is the best plan?
2. Should anything be rolled into a Roth IRA?
3. Should assets be transferred to a fixed or variable annuity?
4. How much money can these assets generate for retirement living?
5. What impact will inflation have on the client's lifestyle?
6. If assets must be depleted, which assets should be liquidated first? Or, should the client deplete some from each asset?
7. If the clients were 40 years old today, what type of strategy should they pursue to provide for a better retirement?

THE PENSION MAXIMIZATION CONCEPT

The pension maximization concept is one that is worth discussing when talking to married clients who are about to receive a pension benefit and must make an irrevocable decision regarding the amount of benefits they will receive each month for the balance of their life and then for the balance of the spouse's life. Typically pensions are offered as an annuity payout in one of the following forms:

1. Single life — monthly income is paid for life and stops when the individual dies
2. Joint and survivor — the survivor receives a reduced amount (perhaps 50%–75%)
3. Lump sum

When helping a client make this decision, several assumptions must be made:

- Is it likely the client will be in a higher or a lower tax bracket during the retirement years?
- What are the current interest rates and will they remain constant?
- What are the ages and health of both spouses?

Example 18. Joe and Mary **(Example 17)**, are looking at payout options for Joe's $400,000 pension benefit. Joe has the choice of the following:

1. A single life benefit of $40,000 per year or $3,333 per month
2. Joint and 75% survivor benefit of $32,000 or $2,667 per month for both and $2,000 per month for Mary after Joe's death
3. Joint and 50% survivor benefit of $36,000 or $3,000 per month for both and $1,500 per month for Mary after Joe's death
4. A lump-sum distribution of $400,000

Pension maximization analyzes the monthly benefit generated under each scenario, and utilizes life insurance to maximize benefits.

Example 18 Continued. Joe explores the lump-sum option. Joe and Mary are in the 28% federal and 3% state tax brackets. Joe must pay taxes on the full amount of the distribution, which equates to $124,000. This leaves him $276,000 to invest for future income purposes. If Joe lives to age 90, he must achieve an after-tax return of approximately 11% to match the income he would receive under the single life-only option.

Note. Advising Joe to take the lump sum under these circumstances may not constitute good advice if his objective is to maximize income for his life and Mary's.

Example 18 Continued. Joe decides he wants to provide income for Mary in the event he predeceases her. He must use either Option 2 or 3. Both of these options reduce the monthly income for Joe and Mary while they are both living.

Joe could consider pension maximization. With a conservative 6% annual return on investment, it is reasonable to assume that a lump sum of $300,000 can generate $24,000 per year for approximately 25 years.

Example 19. Joe **(Example 17)** is a healthy male non-smoker. He could acquire $300,000 of permanent life insurance protection for approximately $6,000 per year.

Joe chooses the single life option which provides him with $40,000 of annual income. From this $40,000, he purchases a permanent life insurance contract with a death benefit of $300,000 for a cost of $6,000 per year. This provides a tax-free lump sum for Mary, which can provide her $24,000 annually (the same as the 75% joint and survivor payout). While both of them are alive, they have an additional $2,000 of disposable income each year ($40,000 per year minus the $6,000 annual insurance premium) vs. the $32,000 available from the joint and 75% survivor benefit.

The following example illustrates how to plan the distribution of assets during retirement and the death impact on the family bank. It illustrates how a taxpayer can build wealth in retirement years.

Example 20. Rex, a widower, is age 65. His only heir is his daughter, Millicent. She is age 25. Rex's assets consist of:

Asset	Value
Qualified pension plan	$1,000,000
Personal residence	1,000,000
Cash and other investments	1,500,000
Total	$3,500,000

To maintain his existing lifestyle, Rex needs $100,000 of after-tax cash flow each year. This amount must be adjusted for 3% inflation. Rex's plan is to create the largest possible family bank.

Rex's advisor can choose from the following options:

1. Start taking a single life distribution from his pension.
2. Roll the pension to an IRA and delay distributions to age 70½, and name his estate the beneficiary for his IRA.
3. Roll the pension to an IRA and convert it to a Roth IRA.
4. Roll his pension to an IRA and delay distributions to age 70½, and utilize the stretch IRA approach.

Option 1 provides Rex with more taxable income than he needs during his lifetime. This may create the smallest estate tax liability. However, it may not necessarily provide the lowest overall tax liability, or the best scenario for keeping the greatest amount of assets in the family.

Option 2 allows for tax deferral during Rex's life. The potential downside to this option is the estate tax his heir must pay at death. Although Rex must take minimum distributions, his estate is still large enough that, under current tax laws, there will likely be an estate tax liability at death.

Choosing between **Options 3 and 4** is more difficult. The reality is that (with all things being equal) there is virtually no difference in the outcome. However, law changes in the future might affect these decisions. If taxes remain the same, or if the taxpayer, as well as his beneficiary, are in a lower bracket, **Option 4** will produce the most favorable results.

Another question to consider is whether there will be sufficient assets to cover final expenses, without distributing principal from the Roth IRA or the traditional IRA. The speculative issue is what will income tax rates be in 10, 15, or 20 years? Assuming an increase in taxes and tax brackets, the Roth IRA conversion may be the favorable choice.

Joint and Survivor Annuity: Spouse Beneficiary

If the employee's sole beneficiary is the employee's spouse as of the annuity starting date for annuity payments, and the distributions satisfy IRC§401(a)(9) without regard to the minimum distribution incidental benefit (MDIB) requirement, the distributions to the employee satisfy the MDIB requirements. For example, if an employee's benefit is being distributed in the form of a joint and survivor annuity for the lives of the employee and his spouse, and the spouse is the sole beneficiary of the employee, the rule is:

The amount of the periodic payment payable to the spouse will not violate the MDIB requirement if it is 100% of the annuity payment payable to the employee, regardless of the difference in the ages between the employee and the employee's spouse.

Joint and Survivor Annuity: Nonspouse Beneficiary

Distributions may commence under a distribution option that is in the form of a joint and survivor annuity for the joint lives of the employee and a beneficiary other than the employee's spouse. The MDIB requirement must be satisfied as of the date distributions commence. The requirement is not satisfied unless under the distribution option, the annuity payments to be made on and after the employee's required beginning date satisfy the following:

1. The periodic annuity payment payable to the survivor must not at any time, on and after the employee's required beginning date, exceed the applicable percentage of the annuity payment payable to the employee using the table below.[8]

2. The applicable percentage is based on the adjusted employee/beneficiary age difference. That difference is determined by first calculating the excess of the age of the employee over the age of the beneficiary based on their ages on their birthdays in a calendar year. If the employee is younger than age 70, the age difference is reduced by the number of years that the employee is younger than age 70 on the employee's birthday in the calendar year that contains the annuity starting date. In the case of an annuity that provides for increasing payments, the requirement is not violated merely because benefit payments to the beneficiary increase, provided the increase is determined in the same manner for the employee and the beneficiary.

Adjusted Employee/Beneficiary Age Difference	Applicable Percentage	Adjusted Employee/Beneficiary Age Difference	Applicable Percentage
10 years or less	100%	26	64%
11	96%	27	63%
12	93%	28	62%
13	90%	29	61%
14	87%	30	60%
15	84%	31	59%
16	82%	32	59%
17	79%	33	58%
18	77%	34	57%
19	75%	35	56%
20	73%	**36**	**56%**
21	72%	37	55%
22	70%	38	55%
23	68%	39	54%
24	67%	40	54%
25	66%		

8. Table from Treas. Reg. §1.401(a)(9)-6

Example 21. Rex is age 65 and begins receiving distributions. Millicent is age 25. The distributions are in the form of a joint and survivor annuity for the lives of Rex and Millicent with payments of $1,000 a month to Rex, and upon Rex's death, $600 a month to Millicent. The projected monthly payment to Millicent is 60% of the monthly amount payable to Rex. The rules for Rex and Millicent are determined as of the annuity starting date.

The adjusted employee/beneficiary age difference is calculated by taking the excess of the employee's age over the beneficiary's age and subtracting the number of years the employee is younger than age 70.

Rex is 40 years older than Millicent, and is receiving his benefits beginning five years prior to attaining age 70. Therefore, the adjusted employee/beneficiary age difference is 35 years. In the previous table, the applicable percentage for a 35-year adjusted employee/beneficiary age difference is 56%. **The plan does not satisfy** the **MDIB requirement** because the distribution option provides that, as of Rex's required beginning date, the monthly payment to Millicent, upon Rex's death (60% of Rex's payment), exceeds the 56% requirement. In this situation, Rex must select a period certain payment.

Period Certain and Annuity Features

If a distribution plan includes a period certain, the amount of the annuity payments payable to the beneficiary need not be reduced during the period certain. In the case of a joint and survivor annuity with a period certain, the amount of the annuity payments payable to the beneficiary must satisfy the terms of the previous table after the expiration of the period certain.

CHARITABLE TRUST AS BENEFICIARY

A charitable remainder unitrust (CRUT) can be an effective tool if there is a sequence of beneficiaries (e.g.; taxpayer leaves his IRA to his daughter for life, and then to his grandson for life). If this is the taxpayer's desire, the use of a CRUT is often more effective than the stretch IRA. However, the effectiveness of using a CRUT diminishes if there is an estate tax liability.

A stretch IRA must make RMD payments to a series of beneficiaries based upon the age of the oldest beneficiary. On the other hand, a CRUT may distribute income based upon the life expectancy of the **youngest** beneficiary. This is most beneficial when the age difference between the oldest and the youngest beneficiary is substantial.

Example 22. Otto Time is 75 years old and has a large IRA. After his death, he wants his sister, Dina Time, who is 70 years old to be the income beneficiary for her life. He names his 50-year-old son, Justin Time, and his 45-year-old daughter, Inna Pinch, as contingent beneficiaries. If he did this utilizing the stretch IRA, all the income distributions will be paid out over Dina's life expectancy (the oldest named beneficiary). By utilizing a CRUT with all three beneficiaries, the income distributions will be paid over the actual lifetime of the last beneficiary to die. This can represent an additional 40 to 50 years of income distribution which translates to a longer tax deferral period.

RAILROAD RETIREMENT

INTRODUCTION[9]

The first industrial pension plan in America was established by a railroad company in 1874. By the 1930s, pension plans were far more developed in the railroad industry than in most other industries but these plans had serious defects which were magnified by the Great Depression. While the social security system was in the planning stage, railroad workers sought a separate railroad retirement system which would continue and broaden the existing railroad programs under a uniform national plan. The proposed social security system was not scheduled to begin monthly

9. www.rrb.gov/opa/agency_overview.html

benefit payments for several years and would not give credit for service performed prior to 1937, but conditions in the railroad industry called for immediate benefit payments based on prior service.

Legislation was enacted in 1934, 1935, and 1937 to establish a railroad retirement system separate from the social security program legislated in 1935. This legislation created the Railroad Retirement Board (RRB), which manages the railroad retirement program.

Although the railroad retirement system has remained separate from the social security system, the two systems closely coordinated earnings credits, benefit payments, and taxes. Financing of the two systems is linked through a financial interchange under which, in effect, the portion of railroad retirement annuities that is equivalent to social security benefits is reinsured through the social security system. The purpose of this financial coordination is to place the social security trust funds in the same position they would be in if railroad service were covered by the social security program instead of the railroad retirement program.

Legislation enacted in 1974 restructured railroad retirement benefits into two tiers to more fully coordinate them with social security benefits. The first tier (**Tier 1**) is based on combined railroad retirement and social security credits using social security benefit formulas. The second tier (**Tier 2**) is based on railroad service only and is comparable to the pensions paid over and above social security benefits in other industries. Tier 2 benefits are also called "non-social security equivalent benefits" (NSSEB).

1099s ISSUED BY RRB

Recipients of railroad retirement benefits receive two Forms 1099 from the RRB. The first statement, Form RRB-1099[10] is blue and shows the amount of benefits received that are equivalent to social security benefits. The second statement, Form RRB-1099-R is green and shows the amount of benefits received comparable to other pensions.

The total Part B Medicare premiums deducted from the railroad retirement annuity may be shown on either Form RRB-1099 or Form RRB-1099-R.

Unfold to see all the tax statements - see reverse side for general information

PAYER'S NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE **UNITED STATES RAILROAD RETIREMENT BOARD** 844 N RUSH ST CHICAGO IL 60611-2092	**2004**		**PAYMENTS BY THE RAILROAD RETIREMENT BOARD**
PAYER'S FEDERAL IDENTIFYING NO. 36-3314600	3. Gross Social Security Equivalent Benefit Portion of Tier 1 Paid in 2004	**14,525.52**	
1. Claim Number and Payee Code **A987-77-7654 1**	4. Social Security Equivalent Benefit Portion of Tier 1 Repaid to RRB in 2004	**0**	COPY C -
2. Recipient's Identification Number **987-77-7654**	5. Net Social Security Equivalent Benefit Portion of Tier 1 Paid in 2004	**14,525.52**	FOR RECIPIENT'S RECORDS
Recipient's Name, Street Address, City, State, and Zip Code **Taxpayer** **Address** **City, State Zip Code**	6. Workers' Compensation Offset in 2004		
	7. Social Security Equivalent Benefit Portion of Tier 1 Paid for 2003		THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.
	8. Social Security Equivalent Benefit Portion of Tier 1 Paid for 2002		
	9. Social Security Equivalent Benefit Portion of Tier 1 Paid for Years Prior to 2002		
	10. Federal Income Tax Withheld **0**	11. Medicare Premium Total **799.20**	

FORM RRB-1099 DO NOT ATTACH TO YOUR INCOME TAX RETURN

[10] Form RRB-1042S for nonresident aliens

PAYERS' NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE **UNITED STATES RAILROAD RETIREMENT BOARD** 844 N RUSH ST CHICAGO IL 60611-2092	**2004** 3. Employee Contributions	**17,682.73**	**ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD**
PAYER'S FEDERAL IDENTIFYING NO. 36-3314600			
1. Claim Number and Payee Code **A987-77-7654 1**	4. Contributory Amount Paid	**6,010.36**	**COPY C -**
2. Recipient's Identification Number **987-77-7654**	5. Vested Dual Benefit	**300.00**	**FOR RECIPIENT'S RECORDS**
Recipient's Name, Street Address, City, State, and ZIP Code **Secret codes** **Name** **Address** **City, State Zip Code**	6. Supplemental Annuity	**200.00**	**THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.**
	7. Total Gross Paid	**6,510.56**	
	8. Repayments	**0**	
	9. Federal Income Tax Withheld	**0**	
	10. Rate of Tax		11. Country / 12. Medicare Premium Total

FORM RRB-1099-R

CALCULATING TAXABLE INCOME FROM RAILROAD RETIREMENT BENEFITS

Form RRB-1099

This form mirrors Form **SSA-1099** issued by the Social Security Administration. It shows the amount of social security **equivalent** benefits paid to a person during the year. The taxable amount of the income shown on Form RRB-1099 is calculated using the same formulas as used for social security benefits.

Railroad retirement annuitants who also receive social security benefits during the tax year receive both Form SSA-1099 and Form RRB-1099. The net social security equivalent benefit shown in Box 5 of Form RRB-1099 is added to the net social security income amount shown in Box 5 of Form SSA-1099 to get the correct total amount of these benefits. This total is entered on line 1 of the Social Security Benefits Worksheet to determine how much of the benefits are taxable.

Additional information on the taxability of these benefits and tax statements can be found in IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits.*

Note. Example 12 of Problem 5 in Chapter 1, "Individual Taxpayer Problems," shows the Social Security Benefits Worksheet.

FORM RRB-1099-R

Box 3: Employee Contributions. Box 3 shows the amount of railroad retirement payroll taxes paid by the employee that exceeds the amount paid in Tier 1 taxes (equivalent to social security payroll taxes). The IRS refers to this amount as an employee's investment in the contract. If this box is blank, the benefits reported on this form are fully taxable.

Note. The amount shown is the latest amount reported which may have increased or decreased from a previous Form RRB-1099-R. A change in the employee contribution may affect the nontaxable portion of the payments for the current tax year and may indicate that an amended return is needed for a prior year.

Box 4: Contributory Amount Paid. Box 4 shows the total amount of benefits paid in the tax year, less any repayments made in that tax year for that tax year. If the year for which any repayments were made is for an earlier year, those repayment amounts are shown in Box 8. The amount in Box 4 is used by employees and survivors of deceased employees covered under general rule provisions to compute their taxable benefits. Most retirees use the simplified method to calculate taxable benefits.

Box 5: Vested Dual Benefit. Box 5 shows the total amount of vested dual benefit (VDB) payments paid, less any VDB repayments made in that tax year for that tax year. **This amount is fully taxable for U.S. federal income tax purposes.** If the year for which the VDB repayments were made is an earlier year or an unknown year, those repayment amounts are shown in Box 8.

Box 6: Supplemental Annuity. Box 6 reports the gross amount of supplemental payments paid in the tax year, less any supplemental annuity repayments made in that tax year for that tax year. **This amount is fully taxable for U.S. federal income tax purposes.** If the year for which the supplemental annuity repayments were made is an earlier year or an unknown year, those repayment amounts are shown in Box 8.

Box 7: Total Gross Paid. Box 7 reports the sum of the amounts shown in Boxes 4, 5, and 6. The amount represents the total pension paid in the tax year indicated on the Form RRB-1099-R.

Box 8: Repayments. Box 8 represents any repayments made to the RRB in the tax year for earlier years or for unknown years. This amount was not deducted from the paid amounts in Boxes 4, 5, or 6. IRS Pub. 575, *Pension and Annuity Income*, contains instructions on how to handle prior year repayments for income tax purposes.

> **Note.** See Problem 6 in Chapter 1, "Individual Taxpayer Problems," for additional information on repayment of benefits under a claim of right.

Box 12: Medicare Premium Total. This is the total amount of Medicare Part B premiums deducted from railroad retirement benefits. The Medicare total is normally shown on Form RRB-1099. However, if Form RRB-1099 is not required for the tax year indicated, then the Medicare total is shown in Box 12.

Simplified Method. Railroad workers must use the simplified method to calculate the taxable benefits amount if:

- They are under age 75 when they retire,
- They started receiving retirement benefits after November 18, 1996, and
- Their RRB-1099-R shows an amount in Box 3 (employee contributions).

> **Note.** Refer to IRS Pub. 575, *Pension and Annuity Income,* and/or IRS Pub. 939, *General Rule for Pensions and Annuities,* if the above conditions do not apply.

Example 23. Ben Landers retired from the railroad several years ago. He received his first pension check on October 1, 2001. At that time he was 65-years old and single. His RRB-1099-R is shown here:

PAYERS' NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE **UNITED STATES RAILROAD RETIREMENT BOARD** 844 N RUSH ST CHICAGO IL 60611-2092	**2004**		**ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD**
PAYER'S FEDERAL IDENTIFYING NO. 36-3314600	3. Employee Contributions	**14,681.32**	
1. Claim Number and Payee Code **A555-55-5555 1**	4. Contributory Amount Paid	**11,645.76**	**COPY C -**
2. Recipient's Identification Number **555-55-5555**	5. Vested Dual Benefit	**1,818.00**	**FOR RECIPIENT'S RECORDS**
Recipient's Name, Street Address, City, State, and ZIP Code	6. Supplemental Annuity	**516.00**	**THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.**
Secret codes **Name** **Address** **City, State Zip Code**	7. Total Gross Paid	**13,979.76**	
	8. Repayments	**0**	
	9. Federal Income Tax Withheld	**2,700.00**	
	10. Rate of Tax		11. Country / 12. Medicare Premium Total

FORM RRB-1099-R

The worksheet he uses to calculate his taxable pension for 2004 is found in IRS Pub. 575 and is shown below.

Worksheet A. **Simplified Method** (Keep for Your Records)

1. Enter the total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a, or Form 1040A, line 12a	**1.**	**11,646**
2. Enter your cost in the plan (contract) at the annuity starting date plus any death benefit exclusion	**2.**	**14,681**
Note: *If your annuity starting date was* ***before this year*** *and you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below. Otherwise, go to line 3.*		
3. Enter the appropriate number from Table 1 below. **But** if your annuity starting date was **after** 1997 **and** the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below.	**3.**	**260**
4. Divide line 2 by line 3	**4.**	**56.47**
5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was **before** 1987, enter this amount on line 8 below and skip lines 6, 7, 10, and 11. Otherwise go to line 6	**5.**	**678**
6. Enter any amounts previously recovered tax free in years after 1986	**6.**	**2,202**
7. Subtract line 6 from line 2	**7.**	**12,479**
8. Enter the **smaller** of line 5 or line 7	**8.**	**678**
9. Taxable amount for year. Subtract line 8 from line 1. Enter the result, but not less than zero. Also, add this amount to the total for Form 1040, line 16b, or Form 1040A, line 12b. **Note**: If your Form 1099-R shows a larger taxable amount, use the amount on this line instead	**9.**	**10,968**
10. Add lines 6 and 8	**10.**	**2.880**
11. Balance of cost to be recovered. Subtract line 10 from line 2	**11.**	**11,801**

Note. Only the amount from Box 4 is entered on line 1, since the amounts in Boxes 5 and 6 are fully taxable.

TABLE 1 FOR LINE 3 ABOVE

IF the age at annuity starting date was...	AND your annuity starting date was— **before** November 19, 1996, enter on line 3...	**after** November 18, 1996, enter on line 3...
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

TABLE 2 FOR LINE 3 ABOVE

IF the combined ages at annuity starting date were...	**THEN** enter on line 3...
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

CIVIL SERVICE RETIREMENT

Retirement funds received by former employees of the U.S. government are generally taxable. However, if the employee made after-tax contributions to the retirement fund, a portion of the benefits are tax-free. For benefit payments which began after November 18, 1996, recipients must use the simplified method to figure the tax-free amount unless, recipients are age 75 and have payments guaranteed for five or more years. Examples of the simplified method are shown previously in this chapter.

Caution. For benefit payments which began prior to November 19, 1996, the recipient may have chosen to use either the simplified method or the general rule. For benefit payments prior to July 2, 1986, either the three-year rule or the general rule applied to the annuity.

4

Retirement benefit statements are issued by the federal government's human resources agency, the Office of Personnel Management (OPM). The following example shows a Form CSA-1099R used to report the retirement benefits received by a former CIA agent.

Example 24. Harry T. Spy retired from the CIA in 1985. At that time, he was required to use the three-year rule. Under this rule, he excluded all the annuity payments from income until he had recovered all of his cost in his retirement fund. His CSA-1099R is shown here:

PAID BY OFFICE OF PERSONNEL MANAGEMENT
RETIREMENT SERVICES PROGRAM
P.O. BOX 45
BOYERS,PA 16017-0045

STATEMENT OF ANNUITY PAID
Copy B - File with Federal tax return

2004

Annuitant's Social Security No.	11. Federal Income Tax withheld	Gross annuity amount
555-99-4110	3312.00	34824.00

Health Insurance Premiums: 3564.12
Retirement Claim No.: JB 007007
Distribution Code: 7-NONDISABILITY

PAID TO
HARRY T. SPY
23 OLD HAND LANE
BEACHES, CA 90120

State 1	State income tax withheld: NONE
State 2	State income tax withheld: NONE
	Original contributions: 16229.00
	Taxable annuity: UNKNOWN

PAYER'S Federal Identification Number: 52-6083699

Form CSA 1099R (Rev. 1/2005)
This information is being furnished to the
Department of Treasury - Internal Revenue Service

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The statement shows that Harry received $34,824 from the OPM in 2004. Of that gross amount, $3,312 was withheld for federal income taxes and $3,564 was withheld for health insurance premiums. These health insurance premiums are deductible on Schedule A.

The OPM has listed his "taxable annuity" as "unknown" since he retired before the OPM began calculating the taxable portion of the benefits. Although the form shows $16,229 as original contributions, Harry cannot use either the general rule or the simplified-method rule to exclude any of these benefits from taxable income because he recovered his cost in the annuity in prior years.

Note. For more information, including rules for disability payments and for survivors of employees and retirees, see IRS Pub. 721, *Tax Guide to U.S. Civil Service Retirement Benefits.*

APPENDIX: RETIREMENT PLAN COMPARISON — 2005

Plan Type	Qualified Employer	Who MUST be covered	Plan establishment deadline	Employee maximum annual deferral
401(k)	• All taxable businesses • Tax-exempt organiz.	Any employee with 1,000 hours of service for 1 year; age 21 or older; can exclude certain employees	Last day of fiscal year; not later than beginning of employee contributions	Up to $14,000; 50+ catch-up contributions of $4,000 allowed
401(k) with Safe Harbor	• All taxable businesses • Tax-exempt organiz.	Same as 401(k)	First day of plan year	Up to $14,000; 50+ catch-up contributions of $4,000 allowed
403(b)	I.R.C. 503(c)(3) organiz.	If one employee participates, all other employees are allowed to participate if they contribute at least $200, regardless of years of service	Last day of fiscal year; not later than beginning of employee contributions	Up to $14,000; 50+ catch-up contributions of $4,000 allowed
Defined Benefit Pension	• All taxable businesses • Tax-exempt organiz. • Gov't entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
Money Purchase	• All taxable businesses • Tax-exempt organiz. • Gov't entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
Profit-Sharing	• All taxable businesses • Tax-exempt organiz. • Gov't entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
SEP	• All taxable businesses • Tax-exempt organiz. • Gov't entities	Any employee who worked 3 or past 5 yrs; age 21 or older; may exclude employees with less than $450 in wages	Tax filing deadline, plus extensions	No pretax contributions, except grandfathered SAR-SEP; 50+ catch-up contributions of $4,000 allowed
SIMPLE IRA	100 employees or less • All taxable businesses • Tax-exempt organiz. • Gov't entities	Any employee earning $5,000 during past 2 years and who is expecting to earn $5000 in current year; can exclude certain employees	Between Jan. 1 and Oct. 1	$10,000; 50+ catch-up contributions of $2,000 allowed

Plan Type	Employer deductible annual combined contribution maximum	Employer contribution requirement	Maximum total allocation to employee's account	Allocation formulas for contributions
401(k)	25% of total eligible payroll (maximum pay per employee is $210,000); plus amount of elective deferrals contributed	None, unless plan is top-heavy	100% employee pay or $42,000 whichever is less	• Nonintegrated allocation • Integrated with Soc. Sec. • Cross tested
401(k) with Safe Harbor	Same as 401(k)	One of the following: • Basic match formula • Enhanced match formula • Nonelective contribution	Same as 401(k)	Same as 401(k)
403(b)	Tax deduction is not issue for tax exempt organizations	none	Same as 401(k)	Does not apply
Defined Benefit Pension	Limited to amount needed to fund future benefits (maximum pay per employee is $210,000)	Contributions based on predicted payouts	No individual accounts	Does not apply
Money Purchase	25% of total eligible payroll (maximum pay per employee is $210,000)	Described in plan document	Same as 401(k)	Same as 401(k)
Profit-Sharing	Same as Money Purchase	Flexible contributions allowed each year; employer must make substantial and recurring contributions	Same as 401(k)	No pretax contributions allowed
SEP	25% of employee's pay or $42,000, whichever is less	None; unless plan is top-heavy	25% of employee's pay or $42,000, whichever is less	• Nonintegrated allocation • Integrated with Soc. Sec.
SIMPLE IRA	$20,000 ($10,000 deferral plus $10,000 maximum match)	Dollar for dollar match up to 3% pay, or 2% gross pay for all eligible employees who earn $5,000 during the year	$14,000	Does not apply

Plan Type	Vesting	Distributions controlled by	Employee Loans	Plan Advantages
401(k)	According to schedule	Employer, through plan terms	Yes	• Employee deferral of taxes • Flexible contributions • More flexibility with amounts due to increased deferral limits
401(k) with Safe Harbor	Immediate 100% on non-safe harbor contributions	Employer, through plan terms	Yes	• No discrimination testing • Employee deferral of taxes • More flexibility with amounts due to increased deferral limits
403(b)	According to schedule	Employer, through plan terms	Yes, except indiv. established accts	• Employee deferral of taxes • More flexibility with amounts due to increased deferral limits
Defined Benefit Pension	According to schedule	Employer, through plan terms	Yes	• Annual retirement benefit can be as high as 100% of the highest 3-yr average pay, up to $170,000 • Guaranteed annuity payments for life
Money Purchase	According to schedule	Employer, through plan terms	Yes	Contribution level specified
Profit-Sharing	According to schedule	Employer, through plan terms	Yes	Flexible contibutions
SEP	100% immediate vesting	Employee	Not applicable	• Minimal paperwork and expense • Minimal tax filing • Ongoing contributions not required • More flexibility with amounts due to increased deferral limits
SIMPLE IRA	100% immediate vesting	Employee	Not applicable	• Minimal paperwork and expense • Minimal tax filing • Employee deferral of taxes • More flexibility with amounts due to increased deferral limits