Chapter 1: Social Security and Retirement Planning

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

SOCIAL SECURITY PLANNING

QUALIFYING FOR RETIREMENT BENEFITS

To qualify for social security retirement benefits, an individual must be fully insured, which means they must have 40 quarters, or 10 years of posted earnings. For 2012, the amount of earnings needed to earn a quarter of coverage is $1,130.[1] The maximum number of quarters of coverage available in one year is four; therefore, an employee earning $4,520 in 2012 will receive credit for four quarters of coverage.

Note. The Food, Energy, and Conservation Act of 2008 allows taxpayers electing the optional method of reporting net earnings from self employment to increase the amount of earnings credited for self employment to the amount needed for four quarters of social security coverage ($4,520 in 2012). A self-employed taxpayer can generally use the optional method only five times in their life; however, farmers can use the optional reporting method every year.[2]

Observation. In advising clients about retirement issues, one of the first questions practitioners should ask is "How many quarters have you paid into social security?" Prior to 2011, this information was provided in a statement mailed to every taxpayer age 25 or older approximately two to three months prior to their birthday each year. However, in March 2011, the Social Security Administration (SSA) announced that it was suspending the mailing of these statements in order to conserve funds. In early 2012, the SSA resumed sending the annual statements only to people age 60 and older.[3] The SSA has also made the statements available online at **www.socialsecurity.gov.**

1. *2012 Social Security Changes.* [www.ssa.gov/pressoffice/colafacts.htm] Accessed on Jan. 30, 2012.
2. *If You Are Self-Employed.* [www.ssa.gov/pubs/10022.html] Accessed on Mar. 13, 2012.
3. *Information Regarding the Social Security Statement.* [http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/463] Accessed on Mar. 2, 2012.

ESTIMATING SOCIAL SECURITY BENEFITS

The SSA offers a variety of online benefit calculators that can be used to estimate an individual's potential benefit amounts using different retirement dates and levels of future earnings. These calculators estimate disability and survivor benefit amounts as well as retirement benefit amounts. The three calculators available at **www.ssa.gov/planners/benefitcalculators.htm** are the following.

1. The **Quick Calculator** gives a simple, rough estimate based on the individual's date of birth and current year's earnings. The individual must be age 21 or older for this calculator to work correctly.
2. The **Online Calculator** requires the user to input their date of birth and complete earnings history to obtain a benefit estimate. The user may project future earnings until their anticipated retirement date.
3. The **Detailed Calculator** provides the most precise estimates. It must be downloaded and installed on the user's computer.

None of the above calculators are linked to the user's social security earnings record but instead use the earnings amounts entered.

The **Retirement Estimator,** available at **www.socialsecurity.gov/estimator**, uses social security earnings records and projected future earnings to estimate the individual's retirement benefit. The actual benefit amount cannot be provided until the individual applies for benefits.

FULL RETIREMENT AGE

It is important to determine the taxpayer's **full retirement age**[4] (FRA) because that determines when they will receive full social security benefits. FRAs are shown in the following table.[5]

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

4. The full retirement age is also referred to as the normal retirement age.

5. *Full retirement Age.* [www.socialsecurity.gov/retire2/retirechart.htm] Accessed on Jan. 31, 2012.

PRIMARY INSURANCE AMOUNT

The **primary insurance amount** (PIA) is the benefit a person receives if they begin receiving benefits at their FRA. At this age, the benefit is neither reduced for early retirement nor increased for delayed retirement.

The PIA is the sum of three separate percentages applied to portions of **average indexed monthly earnings** (AIME).[6] The percentages of the PIA formula are fixed by law, and the dollar amounts in the formula are adjusted annually for changes in the national average wage index. These dollar amounts, called "bend points," govern the portions of the AIME.[7]

The bend points in the year 2012 PIA formula are $767 and $4,624 and apply to workers who first become eligible for retirement benefits in 2012. Their PIA is the sum of:[8]

- 90% of the first $767 of the worker's AIME, plus
- 32% of the AIME over $767 and through $4,624, plus
- 15% of the AIME over $4,624.

Example 1. Meredith retires in 2012 at age 66, which is her FRA. Her AIME is $6,200. Her PIA is calculated as follows.

- 90% × $767 = $690
- 32% × ($4,624 − $767) = $1,234
- 15% × ($6,200 − $4,624) = $236

Meredith's PIA is $2,160 ($690 + $1,234 + $236).

An eligible individual can start receiving social security retirement benefits as early as age 62 or as late as age 70. The individual's monthly benefit is different depending on the age they start receiving it.

Receiving Benefits Early

When an individual starts receiving benefits early (before FRA), the benefits are **reduced** based on the number of months they receive benefits before reaching FRA. Taxpayers born between 1943 and 1954 receive 75% of their PIA if they elect to start receiving benefits at age 62. This percentage gradually decreases for taxpayers born after 1954 but before 1960. Taxpayers born in 1960 and later years receive 70% of their PIA if they elect to start receiving benefits at age 62.

Delaying Benefits

Social security benefits are **increased** by a certain percentage (depending on the date of birth) if a taxpayer delays retirement beyond the FRA. The benefit reaches a maximum once a taxpayer reaches age 70. It will not increase further, even if they continue to delay taking benefits. For persons born in 1943 or later, the credit for each year of delayed retirement after reaching the FRA is 8%.[9]

Example 2. Use the same facts as **Example 1.** If Meredith delays the date that she begins receiving social security benefits until she reaches age 67, her monthly benefit will be $2,333 ($2,160 × 108%).

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6. Up to 35 years of a worker's earnings are indexed to reflect the change in general wage levels that occurred during the worker's years of employment. The indexing series for the years 1951–2010 is available at www.socialsecurity.gov/OACT/COLA/AWI.html. Accessed on Jan. 31, 2012.

7. *Social Security Benefit Amounts*. [www.socialsecurity.gov/OACT/COLA/Benefits.html#aime] Accessed on Jan. 31, 2012.

8. *Primary Insurance Amount*. [www.socialsecurity.gov/OACT/COLA/piaformula.html] Accessed on Jan. 31, 2012.

9. *Effect of Early or Delayed Retirement on Retirement Benefits*. [www.socialsecurity.gov/OACT/ProgData/ar_drc.html] Accessed on Jan. 31, 2012.

FAMILY BENEFITS

Certain family members of an individual who receives social security retirement benefits are also entitled to benefits. These family members include the following.[10]

- Spouses who are age 62 or older
- Spouses who are younger than 62 if they are taking care of a child who is younger than age 16 or disabled
- Former spouses who are age 62 or older
- Unmarried children up to age 18, or up to age 19 if they are full-time students who have not yet graduated from high school
- Unmarried disabled children of any age if the disability started before age 22 (In certain situations, benefits are payable to a disabled child who marries someone who is also eligible as a disabled child.)

Benefits for Spouses

When a worker becomes eligible for retirement benefits, the worker's spouse may be eligible for a benefit based on the worker's earnings. To be eligible, the spouse must be at least age 62 or have a qualifying child in their care. A **qualifying child** for this purpose is a child who is under age 16 or who receives social security disability benefits.

The spousal benefit can be as much as half of the worker's PIA, depending on the spouse's age. If the spouse begins receiving retirement benefits before reaching the FRA, the spouse receives a reduced benefit. However, the spousal benefit is **not** reduced if the spouse is caring for a qualifying child.

A spouse is paid a retirement benefit based on their own earnings if that benefit is **higher** than the spousal benefit. Otherwise, they receive the spousal benefit.

A spouse can begin receiving benefits as early as age 62, but doing so results in a reduction of the spousal benefit. A spousal benefit is reduced $^{25}/_{36}$ of 1% (0.0069) for each month before FRA, up to 36 months. If the number of months before reaching the FRA is greater than 36, the benefit is further reduced $^{5}/_{12}$ of 1% (0.0042) per month. This reduction factor is applied to the base spousal benefit, which is 50% of the worker's PIA.[11]

> **Note.** Relatively few people can begin receiving social security retirement benefits at exactly age 62 because a person must be 62 throughout the first month of retirement. Thus, most early retirees can begin receiving benefits at age 62 and 1 month.[12]

Example 3. Ralph retires at his FRA, and his PIA is $1,600. His wife, Alice, is a homemaker and is not eligible for a retirement benefit based on her own work record. Alice plans to start drawing her spousal benefit the month after she reaches age 62, which is 47 months before her FRA. Her spousal benefit is calculated as follows.

	Formula	Calculation	Result
Base spousal benefit	PIA × 50%	$1,600 × 50%	$800
Reduction: first 36 months	36 months × $^{25}/_{36}$ × 1% = 25%	$800 × 25%	(200)
Reduction: next 11 months	11 months × $^{5}/_{12}$ × 1% = 4.58%	$800 × 4.58%	(37)
Final spousal benefit			$563

10. *Retirement Benefits.* [www.ssa.gov/pubs/10035.pdf] Accessed on Feb. 1, 2012.

11. *Benefits for Spouses.* [www.socialsecurity.gov/OACT/quickcalc/spouse.html] Accessed on Feb. 1, 2012.

12. *Benefit Reduction for Early Retirement.* [www.ssa.gov/oact/quickcalc/earlyretire.html] Accessed on Feb. 1, 2012.

> **Note.** The **base spousal benefit** is 50% of the worker's PIA — even if the worker retired early. Moreover, the worker must file for social security retirement benefits in order for the spouse to be eligible for a spousal benefit. However, an individual who has reached FRA can apply for retirement benefits and then request to have the payments suspended. This entitles the spouse to receive a spousal benefit while the worker earns delayed retirement credits up to age 70.[13]

A spouse who has reached FRA and is eligible for their own retirement benefit can choose to receive only the spouse's benefit. By doing this, the spouse can delay receiving their own retirement benefit until a later date to take advantage of delayed retirement credits.[14]

Benefits for Former Spouses[15]

A divorced spouse can get benefits based on a worker's social security record if the marriage lasted at least 10 years. To qualify, the divorced spouse must be at least age 62 and unmarried.

The retirement benefit a divorced spouse receives has no effect on the benefit amount that the worker and their current spouse are entitled to receive.

If a worker and their ex-spouse are both age 62 or older and have been divorced for at least two years, the ex-spouse can get benefits even if the worker has not retired.

Benefits for Children

Children of an individual receiving social security benefits can be eligible for benefits. To be eligible for benefits, a child must have:

- A parent who is disabled or retired and entitled to social security benefits, or
- A parent who died after working long enough in a job where they paid social security taxes. (See the "Survivor Benefits" section later in this chapter.)

The eligible child can be a biological child, adopted child, or dependent stepchild. In some cases, a child can also be eligible for benefits based on their grandparents' earnings. The child also must be one of the following.

- Unmarried and younger than age 18
- 18−19 years old and a full-time student (no higher than grade 12)
- 18 or older and disabled (The disability must have started prior to age 22.)

A child may receive up to 50% of a parent's PIA or disability benefit. If the parent is deceased, the child may receive up to 75% of the deceased parent's PIA. However, a child's benefit is subject to the maximum family limit, which is discussed next.

Maximum Family Benefit

There is a limit to the monthly amount that family members can be paid on a worker's earning record. The family maximum is computed using a formula similar to that used to compute the PIA. The formula combines four separate percentages applied to portions of the worker's PIA. For 2012, the bend points used in this formula are $980, $1,415, and $1,845.

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13. *Retirement Benefits.* [www.ssa.gov/pubs/10035.pdf] Accessed on Feb. 1, 2012.
14. *Benefits for You as a Spouse?* [www.ssa.gov/retire2/applying6.htm] Accessed on Feb. 2, 2012.
15. Ibid.

The total benefit payable to the family of a worker who attains age 62 or dies in 2012 before attaining age 62 is the sum of:[16]

- 150% of the first $980 of the worker's PIA, plus
- 272% of the workers PIA over $980 through $1,415, plus
- 134% of the worker's PIA over $1,415 through $1,845, plus
- 175% of the worker's PIA over $1,845.

If the sum of benefits payable to family members is greater than the family maximum amount, the benefits are reduced proportionately. However, the worker's benefit is not affected by the family maximum.

Example 4. Nathaniel Thorne, his wife Sophia, and their four children are entitled to social security benefits. Nathaniel's PIA is $2,100. The Thornes' maximum family benefit is computed as follows.

- 150% × $980 = $1,470
- 272% × ($1,415 − $980) = $1,183
- 134% × ($1,845 − $1,415) = $576
- 175% × ($2,100 − $1,845) = $446

The Thornes' maximum family benefit is $3,675 ($1,470 + $1,183 + $576 + $446).

After subtracting Nathaniel's PIA from the maximum family benefit, there is a total of $1,575 ($3,675 family maximum − $2,100 PIA) to divide among Sophia and the four children. Their unadjusted benefit amount is $1,050 each ($2,100 PIA × 50%). Applying the family maximum, each will receive $315 ($1,575 ÷ 5 family members).

SURVIVOR BENEFITS

Certain family members are eligible for survivors' benefits after the death of a person who has worked and paid social security taxes. The length of time a worker needs to work in order for their survivors to be eligible for benefits depends on the worker's age when they die. The requisite length of time increases with the worker's age, but no more than 10 years of work is needed to be covered for all benefits.

Under a special rule, benefits can be paid to the deceased worker's children and spouse who is caring for the children even if the deceased did not have the required number of credits. They can get benefits if the deceased had credit for 1½ years (6 credits) in the three years immediately preceding the death.

> **Note.** If an individual is already receiving retirement or disability benefits at the time of their death, the SSA pays the survivors based on that entitlement.

16. *Formula for Family Maximum Benefit.* [www.socialsecurity.gov/OACT/COLA/familymax.html] Accessed on Feb. 1, 2012.

Eligible Relatives

Survivor benefits can be paid to the following persons.[17]

- A **surviving spouse** may receive full benefits at FRA or reduced benefits as early as age 60. If the surviving spouse is disabled, benefits can begin as early as age 50.
- A **surviving spouse** can receive benefits at any age if they take care of a child of the deceased who is under the age of 16 or disabled and receiving social security benefits.
- The deceased's **unmarried children** who are under age 18 (or up to age 19 if they are full-time students at an elementary or secondary school) can receive benefits. Disabled children can receive benefits at any age if they were disabled before age 22.
- The **dependent parents** of the deceased can receive benefits if they are at least age 62. For the parents to qualify as dependents, the deceased had to provide at least half of their support.
- An **ex-spouse** of the deceased who is at least age 60 (or age 50 if disabled) can get benefits if the marriage lasted at least 10 years. However, the ex-spouse does not have to meet the age or length-of-marriage requirements if they are caring for a child who is younger than age 16 or disabled and is also entitled to benefits based on the deceased's earnings. The child must be the natural or legally adopted child of the ex-spouse.

If a surviving spouse remarries before reaching age 60, their survivors' benefits generally cease. However, if the remarriage occurs after age 60 (or age 50 if disabled), the benefit payments based on the former spouse's work are not affected. At age 62 or older, they may get benefits based on the new spouse's earnings, if that benefit is higher.

Amount of Benefits

The amount of survivor benefits is based on the deceased individual's earnings. If the deceased individual was receiving reduced benefits, the survivors' benefits are based on that amount. The SSA uses the deceased individual's PIA and calculates the percentage payable to the survivors. The percentage depends on the survivors' ages and relationship to the deceased. Following are the most typical situations.[18]

- A surviving spouse who has attained FRA generally receives 100% of the deceased individual's PIA.
- A surviving spouse who is at least age 60 but under FRA receives approximately 71–99% of the deceased individual's PIA.[19]

> **Note.** A widow(er) can switch from their own retirement benefit to a deceased spouse's benefit without a carryover of any early retirement penalty from taking their own benefit prior to FRA.

- A surviving spouse of any age who has a child younger than age 16 receives 75% of the deceased individual's PIA.
- Children receive 75% of the deceased parent's PIA.

Maximum Family Benefit

The same formula used to calculate the maximum family benefit for a retired worker is used to calculate the maximum benefit for a deceased worker's family.

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17. *Survivor's Benefits*. [www.ssa.gov/pubs/10084.html] Accessed on Feb. 7, 2012.

18. Ibid.

19. See www.ssa.gov/survivorplan/1945s.html for a chart with the precise percentages based on the survivor's age at the time they begin receiving benefits. Accessed on Feb. 7, 2012.

DISABILITY BENEFITS

The SSA pays benefits to people who cannot work because they have a medical condition that is expected to last at least one year or result in death.

Note. The SSA also administers the Supplemental Security Income (SSI) program, which pays disability benefits to elderly, blind, and disabled persons who have low income and few resources. More information about SSI is available at **www.ssa.gov/pubs/11000.pdf.**

Earnings Tests

To qualify for social security disability benefits, the disabled person generally must meet **both** of the following earnings tests.

1. A **recent work** test based on the age the person became disabled
2. A **duration of work** test to prove that the person worked long enough under social security

Certain blind workers only have to meet the duration of work test.

Recent Work Test. The following table lists the rules for how much work is needed to satisfy the recent work test. The rules in the table are based on the calendar quarter in which the disabled person turned or will turn a certain age.[20]

Rules for Work Needed for the "Recent Work Test"

If you become disabled . . .	Then you generally need:
In or before the quarter you turn age 24	1.5 years of work during the 3-year period ending with the quarter your disability began.
In the quarter after you turn age 24 but before the quarter you turn age 31	Work during half the time for the period beginning with the quarter after you turned 21 and ending with the quarter you became disabled. Example: If you become disabled in the quarter you turned age 27, then you would need three years of work out of the 6-year period ending with the quarter you became disabled.
In the quarter you turn age 31 or later	Work during five years out of the 10-year period ending with the quarter your disability began.

[20] *Disability Benefits.* [www.ssa.gov/pubs/10029.html] Accessed on Feb. 7, 2012.

Duration of Work Test. To meet this test, the disabled person must have earned at least one credit for each calendar year from the time the individual attained age 22 until the time the individual attained age 62, became disabled, or died.

Following is a table that lists examples of the number of years of work needed to satisfy this test.[21]

Examples of Work Needed for the "Duration of Work" Test

If you become disabled . . .	Then you generally need:
Before age 28	1.5 years of work
Age 30	2 years
Age 34	3 years
Age 38	4 years
Age 42	5 years
Age 44	5.5 years
Age 46	6 years
Age 48	6.5 years
Age 50	7 years
Age 52	7.5 years
Age 54	8 years
Age 56	8.5 years
Age 58	9 years
Age 60	9.5 years

Effect of Other Payments on Disability Benefits[22]

Disability payments from private sources, such as private pension or insurance benefits, do not affect the amount of social security disability benefits. However, workers' compensation and other public disability benefits may reduce social security disability payments. Other public disability payments that may affect social security disability benefits are those paid by a federal, state, or local government that are for disabling conditions that are not job-related.

The following public benefits **do not** affect social security disability benefits.

- Veterans Administration benefits
- State and local government benefits, if social security taxes were deducted from the worker's earnings
- Supplemental security income

If a disabled individual receives workers' compensation or other public disability benefits in addition to social security disability benefits, the total of these benefits cannot exceed 80% of the disabled individual's average current earnings before they became disabled. The social security benefits are reduced until the month the other benefits stop or the disabled person reaches age 65, whichever comes first.

> **Example 5.** Ricci's average current earnings were \$4,000 per month before she became disabled. Ricci and her family would be eligible to receive a total of \$2,200 per month in social security disability benefits. However, Ricci also receives \$2,000 per month from workers' compensation. Because the total amount of benefits she would receive (\$2,200 + \$2,000 = \$4,200) is more than 80% of her average current earnings (\$4,000 × 80% = \$3,200) prior to her disability, her family's social security benefit is reduced by \$1,000 (\$4,200 − \$3,200).

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21. Ibid.

22. *How Workers' Compensation and Other Disability Payments May Affect your Benefits.* Social Security Administration [www.ssa.gov/pubs/10018.html] Accessed on Feb. 7, 2012.

Family Maximum for Disabled Worker

A special formula is used to compute the maximum benefits payable to a disabled worker's family. The maximum for a disabled worker's family is 85% of the worker's AIME. However, it cannot be less than the worker's PIA or more than 150% of the PIA.[23]

Lump-Sum Disability Payments

It takes the SSA an average of three to five months to process an initial application for disability benefits.[24] Most of these applications are initially rejected; thus, a lengthy appeals process may be necessary in order to collect benefits. Those claimants who are successful often receive a lump-sum amount that includes back payments for the previous year(s).

Lump-sum payments are reported in box 3 of either Form SSA-1099, *Social Security Benefit Statement,* or Form RRB-1099, *Payments By The Railroad Retirement Board*. The form indicates the year(s) that the payment covers. However, Form RRB-1099 does not show a breakdown by year of lump-sum payments for years before 2009.

The taxable amount of a lump-sum disability payment for an earlier year may be calculated separately using the taxpayer's income for the earlier year. The taxpayer can use the lump-sum election method if it lowers their taxable benefit. To determine if the lump-sum election method lowers the taxable benefit, the preparer can use the worksheets in IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits.*

Example 6. Anita, who is single, applied for social security disability benefits in 2010 but was told she was ineligible. She appealed the decision and won. In 2011, Anita received a lump-sum payment of $11,000, of which $2,000 was for 2010 and $9,000 was for 2011. Anita's other income for 2010 and 2011 is as follows.

	2010	2011
Wages	$19,000	$ 2,000
Interest income	1,800	2,400
Dividend income	1,100	1,200
Fully taxable pension	0	19,000
Total	$21,900	$24,600

Anita's 2011 Form SSA-1099 follows.

23. *Maximum Benefit for a Disabled-Worker Family.* [www.socialsecurity.gov/OACT/COLA/dibfamilymax.html] Accessed on Feb. 1, 2012.

24. *Disability Benefits.* [www.ssa.gov/pubs/10029.pdf] Accessed on Feb. 23, 2012.

For Example 6

FORM SSA-1099 – SOCIAL SECURITY BENEFIT STATEMENT

2011
- PART OF YOUR SOCIAL SECURITY BENEFITS SHOWN IN BOX 5 MAY BE TAXABLE INCOME.
- SEE THE REVERSE FOR MORE INFORMATION.

Box 1. Name		Box 2. Beneficiary's Social Security Number
Anita		**123-45-6789**
Box 3. Benefits Paid in 2011	Box 4. Benefits Repaid to SSA in 2011	Box 5. Net Benefits for 2011 *(Box 3 minus Box 4)*
*** 11000.00**		**11000.00**

DESCRIPTION OF AMOUNT IN BOX 3

Pd. by direct dep.	**$11,000.00**
Benefits paid in 2011	**$11,000.00**

*** Includes**
$9,000.00 paid in 2011 for 2011
$2,000.00 paid in 2011 for 2010

DESCRIPTION OF AMOUNT IN BOX 4

Box 6. Voluntary Federal Income Tax Withheld

Box 7. Address
145 Ravine Dr.
Carlinville, IL 62626

Box 8. Claim Number *(Use this number if you need to contact SSA.)*
123-45-6789

Form **SSA-1099-SM** (1-2012) **DO NOT RETURN THIS FORM TO SSA OR IRS**

Anita's accountant Robert completes worksheets 1, 2, and 4 in IRS Pub. 915 to determine whether the lump-sum election method results in lower taxable benefits.

1. Robert completes worksheet 1 to calculate the amount of Anita's taxable benefit for 2011 under the regular method.
2. Robert completes worksheet 2 to calculate the taxable part of the lump-sum payment for 2010 under the lump-sum election method.
3. Robert completes worksheet 4 to determine if using the lump-sum election method will lower Anita's taxable benefit.

These worksheets follow.

For Example 6

Worksheet 1.
Figuring Your Taxable Benefits

Keep for Your Records

Before you begin:

- If you are married filing separately and you lived apart from your spouse for all of 2011, enter "D" to the right of the word "benefits" on Form 1040, line 20a, or Form 1040A, line 14a.
- Do not use this worksheet if you repaid benefits in 2011 and your total repayments (box 4 of Forms SSA-1099 and RRB-1099) were more than your gross benefits for 2011 (box 3 of Forms SSA-1099 and RRB-1099). None of your benefits are taxable for 2011. For more information, see *Repayments More Than Gross Benefits*.
- If you are filing Form 8815, Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989, do not include the amount from line 8a of Form 1040 or Form 1040A on line 3 of this worksheet. Instead, include the amount from Schedule B (Form 1040A or 1040), line 2.

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099. Also enter this amount on Form 1040, line 20a, or Form 1040A, line 14a . . . **1.** 11,000

2. Enter one-half of line 1 . . . **2.** 5,500

3. Combine the amounts from:
Form 1040: Lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21
Form 1040A: Lines 7, 8a, 9a, 10, 11b, 12b, and 13 . . . **3.** 24,600

4. Enter the amount, if any, from Form 1040 or 1040A, line 8b . . . **4.** 0

5. Enter the total of any exclusions/adjustments for:
- Adoption benefits (Form 8839, line 24),
- Foreign earned income or housing (Form 2555, lines 45 and 50, or Form 2555-EZ, line 18), and
- Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico . . . **5.** 0

6. Combine lines 2, 3, 4, and 5 . . . **6.** 30,100

7. *Form 1040 filers:* Enter the amounts from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the dotted line next to line 36.
Form 1040A filers: Enter the amounts from Form 1040A, lines 16 and 17 . . . **7.** 0

8. Is the amount on line 7 less than the amount on line 6?
No. STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b, or Form 1040A, line 14b.
Yes. Subtract line 7 from line 6 . . . **8.** 30,100

9. 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 2011, enter $25,000 . . . **9.** 25,000

Note. If you are married filing separately and you lived with your spouse at any time in 2011, skip lines 9 through 16; multiply line 8 by 85% (.85) and enter the result on line 17. Then go to line 18.

10. Is the amount on line 9 less than the amount on line 8?
No. STOP None of your benefits are taxable. Enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b. If you are married filing separately and you **lived apart** from your spouse for all of 2011, be sure you entered "D" to the right of the word "benefits" on Form 1040, line 20a, or on Form 1040A, line 14a.
Yes. Subtract line 9 from line 8 . . . **10.** 5,100

11. 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 2011 . . . **11.** 9,000

12. Subtract line 11 from line 10. If zero or less, enter -0- . . . **12.** 0

13. Enter the **smaller** of line 10 or line 11 . . . **13.** 5,100

14. Enter one-half of line 13 . . . **14.** 2,550

15. Enter the **smaller** of line 2 or line 14 . . . **15.** 2,550

16. Multiply line 12 by 85% (.85). If line 12 is zero, enter -0- . . . **16.** 0

17. Add lines 15 and 16 . . . **17.** 2,550

18. Multiply line 1 by 85% (.85) . . . **18.** 9,350

19. **Taxable benefits.** Enter the **smaller** of line 17 or line 18. Also enter this amount on Form 1040, line 20b, or Form 1040A, line 14b . . . **19.** 2,550

TIP *If you received a lump-sum payment in 2011 that was for an earlier year, also complete Worksheet 2 or 3 and Worksheet 4 to see if you can report a lower taxable benefit.*

Note. Worksheet 1 uses the regular method. With this calculation, Anita's taxable disability benefit for 2011 is $2,550 (line 19 above).

For Example 6

Worksheet 2.
Figure Your Additional Taxable Benefits (From a Lump-Sum Payment for a Year After 1993)

Keep for Your Records

Enter earlier year **2010**

1.	Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 for the earlier year, plus the lump-sum payment for the earlier year received after that year . . . . **1.** 2,000 **Note.** If line 1 is zero or less, skip lines 2 through 20 and enter -0- on line 21. Otherwise, go on to line 2.	
2.	Enter one-half of line 1	**2.** 1,000
3.	Enter your adjusted gross income for the earlier year	**3.** 21,900
4.	Enter the total of any exclusions/adjustments you claimed in the earlier year for: • Adoption benefits (Form 8839) • Qualified U.S. savings bond interest (Form 8815) • Student loan interest (Form 1040, page 1, or Form 1040A, page 1) • Tuition and fees (Form 1040, page 1, or Form 1040A, page 1) • Domestic production activities (for 2005 through 2010) (Form 1040, page 1) • Foreign earned income or housing (Form 2555 or Form 2555-EZ) • Certain income of bona fide residents of American Samoa (Form 4563) or Puerto Rico	**4.** 0
5.	Enter any tax-exempt interest received in the earlier year	**5.** 0
6.	Add lines 2 through 5	**6.** 22,900
7.	Enter your taxable benefits for the earlier year that you previously reported	**7.** 0
8.	Subtract line 7 from line 6	**8.** 22,900
9.	If, for the earlier year, you were: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), married filing separately and you lived apart from your spouse for all of the earlier year, enter $25,000 **Note.** If you were married filing separately and you lived with your spouse at any time during the earlier year, skip lines 9 through 16; multiply line 8 by 85% (.85) and enter the result on line 17. Then go to line 18.	**9.** 25,000
10.	Is the amount on line 8 more than the amount on line 9? **No.** Skip lines 10 through 20 and enter -0- on line 21. **Yes.** Subtract line 9 from line 8	**10.**
11.	Enter $12,000 if married filing jointly for the earlier year; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of the earlier year	**11.**
12.	Subtract line 11 from line 10. If zero or less, enter -0-	**12.**
13.	Enter the **smaller** of line 10 or line 11	**13.**
14.	Enter one-half of line 13	**14.**
15.	Enter the **smaller** of line 2 or line 14	**15.**
16.	Multiply line 12 by 85% (.85). If line 12 is zero, enter -0-	**16.**
17.	Add lines 15 and 16	**17.**
18.	Multiply line 1 by 85% (.85)	**18.**
19.	**Refigured taxable benefits.** Enter the **smaller** of line 17 or line 18	**19.**
20.	Enter your taxable benefits for the earlier year (or as refigured due to a previous lump-sum payment for the year)	**20.**
21.	**Additional taxable benefits.** Subtract line 20 from line 19. Also enter this amount on Worksheet 4, line 20	**21.** 0

CAUTION

Do not file an amended return for this earlier year. Complete a separate Worksheet 2 or Worksheet 3 for each earlier year for which you received a lump-sum payment in 2011.

Note. Worksheet 2 uses the lump-sum election method. It is used to calculate the taxable part of the $2,000 lump-sum disability benefit for 2010 that Anita received in 2011.

For Example 6

Worksheet 4.
Figure Your Taxable Benefits Under the Lump-Sum Election Method (Use With Worksheet 2 or 3)

Keep for Your Records

Complete Worksheet 1 and Worksheets 2 and 3 as appropriate before completing this worksheet.

1.	Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 for 2011, minus the lump-sum payment for years before 2011 . . . **1.** 9,000 **Note.** If line 1 is zero or less, skip lines 2 through 18, enter -0- on line 19 and go to line 20. Otherwise, go on to line 2.		
2.	Enter one-half of line 1	**2.**	4,500
3.	Enter the amount from Worksheet 1, line 3	**3.**	24,600
4.	Enter the amount from Worksheet 1, line 4	**4.**	0
5.	Enter the amount from Worksheet 1, line 5	**5.**	0
6.	Combine lines 2, 3, 4, and 5	**6.**	29,100
7.	Enter the amount from Worksheet 1, line 7	**7.**	0
8.	Subtract line 7 from line 6	**8.**	29,100
9.	Enter the amount from Worksheet 1, line 9. But if you are married filing separately and lived with your spouse at any time during 2011, skip lines 9 through 16; multiply line 8 by 85% (.85) and enter the result on line 17. Then, go to line 18	**9.**	25,000
10.	Is the amount on line 8 more than the amount on line 9? **No.** Skip lines 10 through 18, enter -0- on line 19, and go to line 20. **Yes.** Subtract line 9 from line 8	**10.**	4,100
11.	Enter the amount from Worksheet 1, line 11	**11.**	9,000
12.	Subtract line 11 from line 10. If zero or less, enter -0-	**12.**	0
13.	Enter the **smaller** of line 10 or line 11	**13.**	4,100
14.	Enter one-half of line 13	**14.**	2,050
15.	Enter the **smaller** of line 2 or line 14	**15.**	2,050
16.	Multiply line 12 by 85% (.85). If line 12 is zero, enter -0-	**16.**	0
17.	Add lines 15 and 16	**17.**	2,050
18.	Multiply line 1 by 85% (.85)	**18.**	7,650
19.	Enter the **smaller** of line 17 or line 18	**19.**	2,050
20.	Enter the total of the amounts from Worksheet 2, line 21, and Worksheet 3, line 14, for all earlier years for which the lump-sum payment was received	**20.**	0
21.	**Taxable benefits under lump-sum election method.** Add lines 19 and 20	**21.**	2,050

Next. Is line 21 above smaller than Worksheet 1, line 19?

No. Do not use this method to figure your taxable benefits. Follow the instructions on Worksheet 1 to report your benefits.

Yes. You can elect to report your taxable benefits under this method. **To elect this method:**

1. Enter "LSE" to the left of Form 1040, line 20a, or Form 1040A, line 14a.
2. If line 21 above is zero, follow the instructions in line 10 for "No" on Worksheet 1. Otherwise:
   a. Enter the amount from Worksheet 1, line 1, on Form 1040, line 20a, or on Form 1040A, line 14a.
   b. Enter the amount from line 21 above on Form 1040, line 20b, or on Form 1040A, line 14b.
   c. If you are married filing separately and you **lived apart** from your spouse for all of 2011, enter "D" to the right of the word "benefits" on Form 1040, line 20a, or Form 1040A, line 14a.

Note. Worksheet 4 is used to determine if using the lump-sum election method lowers Anita's 2011 taxable disability benefit.

Robert compares the amounts from worksheet 4, line 21, and worksheet 1, line 19. Because the amount on worksheet 4 is smaller, Anita's taxable benefit will be lower by using the lump-sum election method. Accordingly, Robert enters "LSE" to the left of line 20a on Anita's Form 1040, as shown next.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**	18	Farm income or (loss). Attach Schedule F		18	
	19	Unemployment compensation		19	
	20a	Social security benefits	20a LSE 11,000	**b** Taxable amount 20b	2,050
	21	Other income. List type and amount		21	
	22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶			

Note. See pages 29–42 in the 2005 *University of Illinois Federal Tax Workbook* for more information regarding SSA lump-sum disability payments and repayments of disability benefits. This can be found at **www.TaxSchool.illinois.edu/taxbookarchive.**

WORKING WHILE RECEIVING SOCIAL SECURITY BENEFITS

Many people continue to work after they start receiving social security retirement or survivor benefits. Workers who reach FRA or older may keep all of their social security benefits no matter how much they earn. However, the benefits are reduced for workers who are younger than the FRA and who earn more than certain amounts.[25]

1. For workers who are younger than FRA during **all** of 2012, the SSA deducts $1 for each $2 in earnings above $14,640.

Example 7. Brent files for social security benefits at age 62 in January 2012. His benefit will be $600 per month, or $7,200 for the entire year. During 2012, Brent anticipates that he will earn $20,800 ($6,160 above the $14,640 limit).

The SSA withholds $3,080 of Brent's social security benefit (half of his earnings over the limit). The SSA accomplishes this by withholding all of Brent's benefit payments from January through June 2012. Thus, the SSA withholds $3,600 of Brent's benefit payments ($600 × 6 months), which is $520 more than is required to be withheld ($3,600 − $3,080) based on earnings of $20,800.

Starting in July 2012, Brent receives his $600 benefit, and this amount is paid to him each month for the remainder of 2012. In 2013, the SSA will pay Brent the additional $520 it withheld in June 2012.

2. For workers who reach FRA **during** 2012, the SSA deducts $1 for each $3 in earnings above $38,880 until the month the worker reaches FRA.

Example 8. Cassandra reaches FRA in November 2012. She earned $39,960 from January through October 2012. During this period, the SSA withholds $360 from her benefit (($39,960 − $38,880 limit) ÷ 3). The SSA does this by withholding Cassandra's first check of the year. Beginning in February 2012, she receives her $600 benefit, and this amount is paid to her each month for the remainder of 2012. In January 2013, the SSA will pay Cassandra the remaining $240 ($600 withheld in January 2012 − $360 required deduction).

Special Rule for First Year of Retirement

There is a special rule that applies to the first tax year in which a person receives social security benefits. Under this rule, a retiree who starts receiving benefits in a month other than January can get a full social security check for any whole month they are retired, even though their wage income is more than the annual earnings limit.

A person is considered retired if their monthly earnings are not more than one-twelfth of the annual earnings limit. In 2012, a person under the FRA for the entire year is considered retired if their monthly earnings are $1,220 or less ($14,640 annual limit ÷ 12 months).

Example 9. Jill retired at age 62 on October 30, 2012. Jill worked full-time and earned $45,000 through October. Starting in November, she takes a part-time job that pays her $500 per month. Although Jill's earnings for the year substantially exceed the 2012 annual limit of $14,640, there is no reduction in her social security benefit for November and December. This is because Jill's earnings for those months are less than $1,220, which is the monthly limit for people younger than FRA. Beginning in 2013, only the yearly limits for people younger than the FRA apply to Jill.

For self-employed people, the SSA considers the time spent working in the business to determine whether they are entitled to full retirement benefits. The following general guidelines are used in this determination.

- People who work more than 45 hours per month in self employment are not considered retired.
- People who work less than 15 hours per month are considered retired.
- People who work between 15 and 45 hours per month are not considered retired if they work in a job that requires a lot of skill or if they manage a sizable business.

25. *How Work Affects Your Benefits.* [www.ssa.gov/pubs/10069.html] Accessed on Feb. 8, 2012.

Example 10. Noah retires and applies for social security benefits at age 62 in February 2012. Before applying the earnings test, his benefit is $1,000 per month. Starting in October 2012, Noah begins working as a self-employed consultant. He works 100 hours per month in October through December, and his net earnings from self employment are $22,000.

If the annual earnings test were applied, Noah would lose $3,680 in benefits (($22,000 − $14,640 annual limit) ÷ 2). However, because of the special rule for the first year of retirement, Noah receives full benefits for the months of February through September. Noah is substantially self-employed in October through December, so he will lose his $1,000 benefit payment for each of those months. Beginning in 2013, only the yearly limits for people younger than FRA apply to Noah.

What Income Counts?[26]

The wages of an employee working for someone else count towards social security earnings limits. Wages count when they are earned rather than when they are paid. For example, accumulated sick or vacation pay that is earned in one year but not paid until the following year is counted as earnings for the year it is earned. An employee's contributions to a pension or retirement plan do not count towards the earnings limit if the contribution amount is included in the employee's gross wages.

For self-employed persons, only the net earnings from self employment count toward the earnings limits. Income from self employment generally counts towards the earnings limit when it is received rather than when it is earned. However, income earned prior to the time the self-employed person becomes entitled to social security but which is not paid until after the individual becomes entitled to benefits is not counted towards the earnings limit.

The following types of income are **not** counted towards the social security earnings limits.

- Veterans or military retirement benefits
- Other government benefits
- Investment earnings
- Interest income
- Pensions
- Annuities
- Capital gains

Effect on Family Members

When a worker's earnings affect their social security retirement benefit, the reduction may also affect other family members. If a spouse and/or children receive benefits based on the worker's record, excess earnings reduce the worker's benefit payment, which also decreases the amount payable to family members.

Example 11. Raj, age 63, receives social security retirement benefits of $1,200 per month. His wife, Padma, receives half of Raj's retirement benefit, or $600 per month. Raj's earnings in 2012 are $1,000 over the earnings limit, so his benefit is reduced by $500 ($1 for every $2 over the limit). Padma's spousal benefit is reduced by $250 (½ of $500).

26. Ibid.

Effect of Earnings on Later Retirement Benefits[27]

Retirement benefits are increased at FRA for individuals who had benefits withheld due to earlier earnings.

Example 12. Lillie claims retirement benefits when she turns 62 in 2012. She then returns to work and has 12 months of benefits withheld. Lillie's retirement benefit will be recalculated when she reaches her FRA of 66.

The SSA reviews the records each year for all social security recipients who work. It recalculates the benefits for each individual and pays any additional benefit in December of the following year. For example, increases are paid in December 2012 for individuals whose 2011 earnings raised their benefit. These increases are retroactive to January 2012.

DECIDING WHEN TO DRAW SOCIAL SECURITY BENEFITS

There is no easy answer to the question every prospective retiree faces: "What is the 'best age' to start receiving social security retirement benefits?" It is a personal choice and everyone should make an informed decision based on their individual and family circumstances.

As discussed earlier, an individual's monthly benefit differs based on the age when they start receiving benefits. The general guidelines are summarized as follows.

- Individuals who start receiving benefits before their FRA will have smaller payments but will receive them for a longer period of time.
- Individuals who start receiving benefits at or after reaching their FRA will have larger monthly payments for a shorter period of time.
- The amount an individual receives when they start their benefit establishes the base amount for payments they will receive for the rest of their life.

There are many factors to consider in making the decision about when to claim retirement benefits. Some of the more prominent considerations follow; however, this list is not intended to be comprehensive.[28]

1. Does the individual plan to continue working? As discussed earlier in this chapter, if an individual continues to work before reaching FRA, some of their benefit payments may be reduced.
2. How long can the individual reasonably expect to live? It is important to plan for the long term. A man who turned 65 in 2011 could expect to live another 18.7 years, while a woman of the same age could expect to live another 20.8 years.[29] Those who expect to live long lives may need the extra money that comes from delaying social security benefits. On the other hand, an individual who has a chronic illness or a genetic predisposition to a shorter-than-average life may be better off drawing social security benefits as soon as permitted.

Note. Social security retirement payments are intended to be actuarially equivalent, which means that lifetime benefits should be the same, on average, regardless of the timing of the first benefit payment. However, a 2001 study by Duggan and Soares indicates that the gender-neutral actuarial adjustments used in determining social security benefits result in a pattern of actuarial nonequivalence. The study reports that there is little actuarial incentive for men to delay their initial benefit claim and that this disincentive is strongest for low-earning men. In contrast, most women have little actuarial incentive to accept benefits early.[30]

27. Ibid.

28. *Other Things to Consider.* [www.ssa.gov/retire2/otherthings.htm] Accessed on Feb. 10, 2012.

29. Ibid.

30. Duggan, James E., & Soares, Christopher J. (2001, Nov.). Actuarial Nonequivalence in Early and Delayed Social Security Benefit Claims. *Public Finance Review,* 188–207 (2002, May). [www.treasury.gov/resource-center/economic-policy/Documents/rp0102.pdf] Accessed on Feb. 10, 2012.

3. Does the individual have health insurance? Many people who stop working lose employer-provided health insurance in addition to their paychecks. Although there are some exceptions, most people are not covered by Medicare until they reach age 65.

> **Note.** Most people should sign up for Medicare Part B (medical insurance) when they become eligible at age 65, even if they are covered by other health insurance. A delay past the initial enrollment period (which begins three months before the 65th birthday and ends three months after that birthday) may cause a delay in coverage and result in higher premiums.[31]

4. Is the individual eligible for benefits based on someone else's record? If so, the following options may be available.

   a. Those who qualify as a widow(er) or surviving divorced spouse may choose to apply for survivors' benefits now and delay their own retirement benefit until later.

   b. A worker who has reached FRA can apply for retirement benefits and then ask to have the payments suspended. This enables the worker's spouse to receive benefits while the worker continues to earn delayed retirement credits.

   c. An individual who has reached FRA and is also eligible for a spouse's or ex-spouse's benefit as well as their own retirement benefit can elect to receive only the spouse's benefit. That way, they can delay receiving their own retirement benefit until a later time when they can take advantage of delayed retirement credits.

5. Does the individual have other income to support them if they delay taking their benefit?

   a. If they do not need the benefit immediately, they may decide to wait until a later time and take advantage of delayed retirement credits. On the other hand, an individual may decide to choose early retirement and increase the value of their benefit by investing instead of spending it.

   b. Some people take early social security benefits out of necessity, due to unemployment or other financial difficulties. But doing so may mean that their financial problems will continue or even worsen as they struggle to live on permanently reduced benefits.

6. Will other family members qualify for benefits based on the worker's record? If an individual begins receiving benefits early, a surviving spouse will not receive a full benefit based on the deceased's earnings record. On the other hand, an individual may want to receive benefits early if they have children under age 18 (or under age 19 for full-time elementary or high school students) who can also receive benefits.

SOCIAL SECURITY PAYBACK OPTION

Under limited conditions, individuals can reset their social security benefits if they have taken early benefits and then later regret doing so. They must file Social Security Form 521 and pay back all benefits received to date in one lump sum. They have only 12 months to reverse their initial decision and are entitled to only one reset per lifetime.

> **Note.** For more information, see page 271 in the 2011 *University of Illinois Federal Tax Workbook.*

31. *Medicare.* [www.ssa.gov/pubs/10043.html#generalEnrollment] Accessed on Feb. 10, 2012.

TAXABILITY OF SOCIAL SECURITY BENEFITS

Whether social security benefits are taxable depends on total income and marital status. Benefits are taxed using a 2-tier system under IRC §86. If the sum of the recipient's **provisional income** exceeds statutory thresholds, up to 85% of social security benefits can be taxable. "Provisional income" is the total of:

1. One-half of social security benefits, plus
2. Modified adjusted gross income (MAGI). For this purpose, MAGI is calculated by adding the following items to the taxpayer's AGI.[32]
   a. Exclusions for interest from U.S. savings bonds used to pay higher education expenses
   b. Exclusions for employer-provided adoption assistance
   c. Deductions for interest on qualified educational loans
   d. Exclusions for foreign earned income or foreign housing
   e. Exclusions for income earned by bona fide residents of American Samoa or Puerto Rico
   f. Tax-exempt interest

If provisional income is below the base amount of the first tier, none of the benefit is taxable. The first tier base amounts are as follows.

- $25,000 for single, head of household, or qualifying widow(er) with a dependent child
- $25,000 for married individuals filing separately who did not live with their spouses at any time during the year
- $32,000 for married couples filing jointly
- $0 for married persons filing separately who lived with their spouse at any time during the year

If provisonal income is above the base amount of the first tier but below the base amount for the second tier, up to 50% of the benefit is taxable. The second tier **adjusted base amounts** are as follows.

- $34,000 for single, head of household, or qualifying widow(er)
- $34,000 for married individuals filing separately who did not live with their spouses at any time during the year
- $44,000 for married couples filing jointly
- $0 for married persons filing separately who lived with their spouse at any time during the year

Note. None of the above threshold amounts are indexed for inflation.

For taxpayers with provisional income between the first and second tiers, the amount of social security benefits subject to taxation is the lesser of:

- One-half of social security benefits, or
- One-half of provisional income in excess of the first tier base amount.

32. IRC §86(b)(2).

If provisional income is above the second tier adjusted base amounts, the social security benefit subject to taxation is the lesser of:

1. 85% of total social security benefits, or
2. 85% of provisional income above the second tier adjusted base amount, plus the lesser of:
   a. $4,500 (single, HoH, QW, or MFS individuals who did not live with their spouses) or $6,000 (MFJ taxpayers), or
   b. One-half of social security benefits.

Note. For more information on social security income taxation, see pages 191–194 in the 2011 *University of Illinois Federal Tax Workbook.*

EFFECT OF GOVERNMENT PENSION ON SOCIAL SECURITY BENEFITS

BACKGROUND

Approximately 96% of all workers in the United States are covered by social security. However, every state has some public employees who are not covered by social security. These public employees predominantly work for state and local governments and also include most federal workers who were hired before 1984.[33]

Many of the public employees who are not covered by social security are nonetheless affected by provisions of the social security system either because they have a spouse contributing to social security or because they worked in a job covered by social security at some point in their careers. The **Windfall Elimination Provision (WEP)** was designed to remove an unintended advantage in the social security benefit formula for some people who receive a government pension. The **Government Pension Offset (GPO)** reduces benefits for certain spouses who receive a government pension.

WINDFALL ELIMINATION PROVISION

The WEP affects the calculation of social security benefits for individuals who receive a pension from work not covered by social security. The pension such individuals receive may reduce their social security benefits.

Rationale for WEP

The SSA benefit formula gives a higher return on lower-paid workers' pre-retirement earnings than that received by highly paid workers. For example, lower-paid workers can get a social security benefit of approximately 55% of their pre-retirement earnings, while the average replacement rate for highly paid workers is 25%.

Before 1983, people who spent most of their careers in jobs not covered by social security had their social security benefit calculated as though they were long-term, low-wage workers. This gave them the advantage of receiving a social security benefit representing a higher percentage of their earnings, while also receiving a pension from a job where they did not pay social security taxes. Congress passed the WEP to remove that advantage.[34]

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33. Government Pension Offset (GPO) and Windfall Elimination Provision (WEP): Policies Affecting Pensions from Work Not Covered by Social Security. Hearing before the Senate Finance Committee. Nov. 6, 2007.

34. *Windfall Elimination Provision.* [www.ssa.gov/pubs/10045.html] Accessed on Feb. 17, 2012.

Application of WEP

The WEP primarily affects individuals who earned a pension in a job where they did not pay social security taxes and who also worked in other jobs long enough to qualify for social security retirement or disability benefits. The WEP may apply to individuals who:

- Reached age 62 or became disabled after 1985, and
- First became eligible for a monthly pension based on work where they did not pay social security taxes after 1985.

The WEP **does not apply** to individuals who fall into one of the following categories.

- They first became federal workers after 1983.
- They were employed on December 31, 1983, by a nonprofit organization that did not initially withhold social security taxes from their pay but later began withholding social security taxes.
- Their only pension is based on railroad employment.
- The only employment in which they did not pay social security taxes was before 1957.
- They have 30 or more years of **substantial earnings** under social security. The annual amounts that are considered substantial earnings are listed in the following table.[35]

Year	Substantial Earnings	Year	Substantial Earnings
1937–54	$ 900	1989	$ 8,925
1955–58	1,050	1990	9,525
1959–65	1,200	1991	9,900
1966–67	1,650	1992	10,350
1968–71	1,950	1993	10,725
1972	2,250	1994	11,250
1973	2,700	1995	11,325
1974	3,300	1996	11,625
1975	3,525	1997	12,150
1976	3,825	1998	12,675
1977	4,125	1999	13,425
1978	4,425	2000	14,175
1979	4,725	2001	14,925
1980	5,100	2002	15,750
1981	5,550	2003	16,125
1982	6,075	2004	16,275
1983	6,675	2005	16,725
1984	7,050	2006	17,475
1985	7,425	2007	18,150
1986	7,875	2008	18,975
1987	8,175	2009–2011	19,800
1988	8,400	2012	20,475

35. *Windfall Elimination Provision.* [www.ssa.gov/pubs/10045.html] Accessed on Feb. 13, 2012.

Calculation of Reduced Benefits

As described earlier in this chapter, the PIA is calculated by separating average earnings into three amounts and multiplying these amounts by factors of 90%, 32%, and 15%, respectively. The total of the three products is the monthly PIA.

For workers subject to the WEP, the 90% factor is reduced to 40% for workers who attained age 62 or became disabled in 1990 or later and had no more than 20 years of substantial earnings. However, for workers who have 21–29 years of substantial earnings under social security (see preceding table), the 90% factor is reduced to between 45 and 85%.[36]

Years of Substantial Earnings	Percentage
30 or more	90 percent
29	85 percent
28	80 percent
27	75 percent
26	70 percent
25	65 percent
24	60 percent
23	55 percent
22	50 percent
21	45 percent
20 or less	40 percent

The following table illustrates how the regular benefit calculation and WEP modified formula compare for **a worker who retires in 2012 with AIME of $3,000.**

Regular Formula		WEP Formula	
90% of first $767	$ 690	40% of first $767	$ 307
32% of earnings over $767 and through $4,624 ($3,000 − $767 × 32%)	715	32% of earnings over $767 and through $4,624	715
15% over $4,624	0	15% over $4,624	0
Total	$1,405	Total	$1,022

The WEP reduces the social security benefit for the worker who retires in 2012 with 20 or fewer years of substantial earnings by $383 ($1,405 − $1,022 in the above table). Because the WEP reduction only applies to the first bracket in the benefit formula (90% versus 40%), the WEP reduction remains a flat $383 for workers whose 2012 AIME amounts exceed the first bend point of $767.

As explained earlier, the WEP reduction is affected by the number of years a worker had substantial earnings subject to social security taxes. The following chart shows the **maximum** monthly amount that a worker's benefit can be reduced for an eligibility year (ELY) if they had fewer than 30 years of substantial earnings.[37] The chart does not reflect the effect of factors such as cost-of-living adjustments or early or delayed retirement.

36. Ibid.

37. *How the Windfall Elimination Provision Can Affect Your Social Security Benefit.* [www.socialsecurity.gov/retire2/wep-chart.htm] Accessed on Feb. 14, 2012.

Maximum Monthly Amount Your Benefit May Be Reduced Because of the Windfall Elimination Provision (WEP) [a]

	Years of Substantial Earnings										
ELY	<20	21	22	23	24	25	26	27	28	29	30
1990	$178.0	$160.2	$142.4	$124.6	$106.8	$89.0	$71.2	$53.4	$35.6	$17.8	$0.0
1991	185.0	166.5	148.0	129.5	111.0	92.5	74.0	55.5	37.0	18.5	0.0
1992	193.5	174.2	154.8	135.5	116.1	96.8	77.4	58.1	38.7	19.4	0.0
1993	200.5	180.5	160.4	140.4	120.3	100.3	80.2	60.2	40.1	20.1	0.0
1994	211.0	189.9	168.8	147.7	126.6	105.5	84.4	63.3	42.2	21.1	0.0
1995	213.0	191.7	170.4	149.1	127.8	106.5	85.2	63.9	42.6	21.3	0.0
1996	218.5	196.7	174.8	153.0	131.1	109.3	87.4	65.6	43.7	21.9	0.0
1997	227.5	204.8	182.0	159.3	136.5	113.8	91.0	68.3	45.5	22.8	0.0
1998	238.5	214.7	190.8	167.0	143.1	119.3	95.4	71.6	47.7	23.9	0.0
1999	252.5	227.3	202.0	176.8	151.5	126.3	101.0	75.8	50.5	25.3	0.0
2000	265.5	239.0	212.4	185.9	159.3	132.8	106.2	79.7	53.1	26.6	0.0
2001	280.5	252.5	224.4	196.4	168.3	140.3	112.2	84.2	56.1	28.1	0.0
2002	296.0	266.4	236.8	207.2	177.6	148.0	118.4	88.8	59.2	29.6	0.0
2003	303.0	272.7	242.4	212.1	181.8	151.5	121.2	90.9	60.6	30.3	0.0
2004	306.0	275.4	244.8	214.2	183.6	153.0	122.4	91.8	61.2	30.6	0.0
2005	313.5	282.2	250.8	219.5	188.1	156.8	125.4	94.1	62.7	31.4	0.0
2006	328.0	295.2	262.4	229.6	196.8	164.0	131.2	98.4	65.6	32.8	0.0
2007	340.0	306.0	272.0	238.0	204.0	170.0	136.0	102.0	68.0	34.0	0.0
2008	355.5	320.0	284.4	248.9	213.3	177.8	142.2	106.7	71.1	35.6	0.0
2009	372.0	334.8	297.6	260.4	223.2	186.0	148.8	111.6	74.4	37.2	0.0
2010	380.5	342.5	304.4	266.4	228.3	190.3	152.2	114.2	76.1	38.1	0.0
2011	374.5	337.1	299.6	262.2	224.7	187.3	149.8	112.4	74.9	37.5	0.0
2012	383.5	345.2	306.8	268.5	230.1	191.8	153.4	115.1	76.7	38.4	0.0

[a] Important: The maximum amount may be overstated. The WEP reduction is limited to one-half of your pension from non-covered employment.

The reduction in an individual's social security benefit cannot be more than half of their pension that is based on earnings after 1956. This "guarantee" is designed to help protect workers with low pensions.

> **Example 13.** Doris receives a monthly government pension of $600. She claims her social security retirement benefit in 2012 at her FRA. Her benefit cannot be reduced more than $300 (half of her monthly pension).

The SSA has an online calculator that can be used to estimate the retirement or disability benefits for workers affected by the WEP. The calculator is available at **www.socialsecurity.gov/retire2/anyPiaWepjs04.htm.**

Effect of WEP on Dependents and Survivors

Because dependents' benefits are derived from the worker's benefit, the WEP affects dependents' benefits as well. However, the WEP does not affect benefits paid to survivors.[38]

> **Example 14.** Dallas and Savannah both claim their social security retirement benefits at their FRA. Dallas also receives a pension based on work not covered by social security. His benefit amount using the WEP formula is $1,000 per month. His wife Savannah receives a spousal benefit of $500 per month (half of Dallas' benefit amount).
>
> If Dallas dies before Savannah, the WEP reduction will be removed. Savannah's benefit as a surviving spouse will be refigured using the regular benefit formula.

Although the WEP does not affect survivor benefits, these benefits may be reduced because of the government pension offset, which is explained in the following section.

38. *Effect of the Windfall Elimination Provision on Dependents and Survivors.* [http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/1266/related/1] Accessed on Feb. 14, 2012.

GOVERNMENT PENSION OFFSET

The GPO reduces social security benefits for certain spouses and surviving spouses who receive a government pension.

Rationale for GPO

Social security spousal benefits were established in the 1930s to compensate spouses who stayed home to raise a family and who were financially dependent on a working spouse. For individuals who qualify for both a social security benefit based on their own earnings and a spousal benefit based on their spouse's earnings, the "dual entitlement" rule caps the benefit at the higher of the worker's own benefit or the spousal benefit.

The GPO has a purpose similar to the dual entitlement provision and applies to individuals who qualify for both a government pension based on their work that is not covered by social security and a social security spousal benefit based on a spouse's work in covered employment. The GPO and the dual entitlement provision have the same intent — to reduce the social security spousal benefit of persons who are not financially dependent on their spouses.[39]

Application of GPO

The GPO applies to individuals who qualify for **both** of the following.

- A government pension based on government employment that is **not** covered by social security
- A social security spousal benefit

Social security benefits as a spouse or surviving spouse are **not** reduced for individuals who fall into one of the following categories.[40]

1. They are receiving a government pension that is not based on earnings.
2. They are a federal, state, or local government employee whose government pension is based on a job for which they were paying social security taxes, and
    a. They filed for and were entitled to spouse's or widow(er)'s benefits before April 1, 2004, or
    b. Their last day of employment (for pension purposes) was before July 1, 2004, or
    c. They paid social security taxes on their earnings during the last 60 months of government service. (Under certain conditions, fewer than 60 months are required for people whose last day of employment was between June 30, 2004, and March 2, 2009.)
3. They are a federal employee who elected to switch from the Civil Service Retirement System to the Federal Employees' Retirement System after December 31, 1987, and
    a. They filed for and were entitled to spouse's or widow(er)'s benefits before April 1, 2004, or
    b. Their last day of service for pension purposes was before July 1, 2004, or
    c. They paid social security taxes on their earnings for 60 months during the period beginning January 1988 and ending with the first month of benefit entitlement.
4. They received or were eligible to receive a government pension before December 1982 and meet all the requirements for social security spousal benefits.
5. They received or were eligible to receive a federal, state, or local government pension before July 1, 1983, and were receiving one-half of their support from their spouse.

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39. Shelton, Alison M. Feb. 10, 2011. Congressional Research Service. [www.leahy.senate.gov/imo/media/doc/Social%20Security%20The%20Government%20Pension%20Offset%20%28GPO%29%202.10.11.pdf] Accessed on Feb. 16, 2012.

40. *Government Pension Offset.* [www.ssa.gov/pubs/10007.html] Accessed on Feb. 15, 2012.

Calculation of Reduction

The GPO reduction in social security spousal benefits is two-thirds of the government pension that is not covered by social security. For individuals who take their government pension in a lump sum, the SSA calculates the GPO reduction as though the individual chose monthly pension payments.

Example 15. Viola receives a monthly civil service pension of $600. Her husband, Reed, receives a social security retirement benefit of $1,000 per month. Before applying the GPO reduction, Viola is eligible for a spousal benefit of $500 (half of $1,000). However, her spousal benefit is reduced by two-thirds of her monthly pension; therefore, Viola receives $100 per month from social security ($500 – ($600 × $^2/_3$)).

The GPO reduction can completely eliminate the social security spousal benefit. In fact, for 74% of those with spousal benefits reduced by the GPO, the reduction is large enough to fully offset any potential spousal benefit. This occurs either because the government pension is relatively large or the potential social security spousal benefit is relatively small.[41]

Example 16. Paul is a retired University of Illinois professor who receives a monthly pension of $6,000. His wife, Mildred, receives a social security retirement benefit of $1,500 per month. Before applying the GPO reduction, Paul is eligible for a social security spousal benefit of $750 (half of $1,500). However, because Paul's GPO reduction is more than the amount of his spousal benefit ($6,000 × $^2/_3$ = $4,000), he does not receive a social security spousal benefit.

The GPO reduction also applies to a surviving spouse's benefit.

Example 17. Use the same facts as **Example 16.** If Mildred predeceases Paul, he would be entitled to a social security survivor benefit of $1,500 per month before applying the GPO reduction. However, because the GPO reduction of $4,000 is more than the amount of the survivor's benefit, he will not receive a social security benefit as a widower.

BENEFITS AFFECTED BY BOTH WEP AND GPO[42]

Many individuals whose spouse's or surviving spouse's benefits are affected by the GPO have earned enough coverage to qualify for social security retirement benefits on their own work records. Because they receive a government pension, the social security benefits they receive on their own records are likely subject to the WEP reduction.

If a person is subject to both the WEP and GPO, the calculations are done in the following order.

Step 1. The retired or disabled worker's benefit is computed under the WEP benefit formula.

Step 2. The potential benefit as a spouse or surviving spouse is determined based on the other spouse's work record.

Step 3. The dual-entitlement provision is applied. Under this provision, the potential benefit as a spouse or surviving spouse is reduced by the amount of the person's own retirement or disability benefit.

Step 4. The remaining benefit as a spouse or surviving spouse (if any) is subject to the GPO. Thus, the spouse's or surviving spouse's benefit is reduced by two-thirds of the person's own pension from noncovered employment.

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41. Shelton, Alison M. Feb. 10, 2011. Congressional Research Service. [www.leahy.senate.gov/imo/media/doc/Social%20Security%20The%20Government%20Pension%20Offset%20%28GPO%29%202.10.11.pdf] Accessed on Feb. 16, 2012.

42. *Benefits Affected by GPO and WEP.* [http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/1257/~/benefits-affected-by-gpo-and-wep] Accessed on Mar. 5, 2012.

Example 18. Laura is a widow who is entitled to a social security retirement benefit of $300 based on her own work record. She is entitled to a potential benefit of $1,000 based on her deceased husband's record. Laura also receives a government pension of $600 from noncovered employment. Her benefit is calculated as follows.

Step 1. Laura's social security retirement benefit calculated under the WEP formula is $300.

Step 2. Laura's potential benefit as a surviving spouse is $1,000.

Step 3. Laura's retirement benefit after applying the dual-entitlement provision is $700 ($1,000 Step 2 amount − $300 Step 1 amount).

Step 4. Laura's remaining benefit of $700 is subject to a GPO reduction of $400 ($600 pension × $^2/_3$). Thus, Laura's surviving spousal benefit is $300.

Laura receives a total benefit of $1,200 per month ($300 Step 1 amount + $300 Step 4 amount + $600 pension).

STRATEGIES DURING RETIREMENT YEARS

Making the most of one's "golden years" requires continual planning. Retirees who are fortunate enough to be able to live comfortably after retirement often seek advice about strategies that will allow them to pass the maximum amount on to their heirs. Other retirees seek advice about how to minimize the taxation of their retirement income in order to facilitate a higher quality of retirement and more financial security. Financial planning for older clients involves a broad range of issues. This section discusses only a small selection of these issues; a complete discussion is beyond the scope of this chapter.

The impact that pensions, IRA withdrawals, and other types of retirement income have on the taxation of social security must not be overlooked. By lowering provisional income (as described earlier in this chapter), taxpayers can lower the taxable portion of their social security benefit or even completely avoid taxation of the benefit.

Example 19. Mason and Annika Jarvis receive a total of $2,500 per month in social security retirement benefits. They estimate that they need to withdraw a total of $30,000 from their IRAs during the year to supplement their social security in order to allow them to maintain their lifestyle. Mason and Annika are contemplating withdrawing an additional $5,000 per year to pay down their 3.875% mortgage.

Their accountant Penny analyzes the tax consequences of the two alternatives. Penny obtains the following reports from her tax software for the **first alternative** ($30,000 social security benefit + $30,000 IRA withdrawals).

For Example 19 — Alternative 1, page 1 of 2

2011 **Federal Worksheets** **Page 1**

Client RETIRE1 **Mason and Annika Jarvis**

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IRA Distribution Schedule

Taxpayer - Payor	Total Received	Taxable Amount	Federal W/H	State W/H
	30,000.	30,000.		
Grand Total	30,000.	30,000.	0.	0.

Social Security Benefits Worksheet (Form 1040, Line 20b)

1. Social security benefits (SSA-1099, box 5)	30,000.
2. Enter one-half of line 1	15,000.
3. Add amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21 (add back excludable interest from Form 8815)	30,000.
4. Enter the amount from Form 1040, line 8b	0.
5. Add lines 2, 3 and 4	45,000.
6. Add amounts from Form 1040, lines 23 through 32, and any amount entered on the dotted line next to line 36	0.
7. Subtract line 6 from line 5 (not less than 0)	45,000.
8. Threshold for your filing status	32,000.
9. Subtract line 8 from line 7 (not less than 0)	13,000.
10. Additional threshold for your filing status	12,000.
11. Subtract line 10 from line 9 (not less than 0)	1,000.
12. Enter the smaller of line 9 or line 10	12,000.
13. Enter one-half of line 12	6,000.
14. Enter the smaller of line 2 or line 13	6,000.
15. Multiply line 11 by 85% (.85)	850.
16. Add lines 14 and 15	6,850.
17. Multiply line 1 by 85% (.85)	25,500.
18. Taxable social security benefits (the smaller of line 16 or line 17)	6,850.

Note. This worksheet assumes a $30,000 social security benefit plus a $30,000 taxable IRA distribution.

For Example 19 — Alternative 1, page 2 of 2

2011 Federal Income Tax Summary — Page 2

Client RETIRE1 — **Mason and Annika Jarvis**

3/01/12 — 2:04 PM

INCOME	
Taxable IRA distributions	30,000
Taxable social security benefits	6,850
Total income	36,850
ADJUSTMENTS TO INCOME	
Total adjustments	0
Adjusted gross income	36,850
ITEMIZED DEDUCTIONS	
Taxes	702
Total itemized deductions	702
TAX COMPUTATION	
Standard deduction	13,900
Larger of itemized or standard deduction	13,900
Income prior to exemption deduction	22,950
Exemption deduction	7,400
Taxable income	15,550
Tax before credits	1,558
CREDITS	
Total credits	0
Tax after credits	1,558
OTHER TAXES	
Total tax	1,558
PAYMENTS	
Total payments	0
REFUND OR AMOUNT DUE	
Underpayment penalty	31
Amount you owe	1,589
TAX RATES	
Marginal tax rate	10.0%
Effective tax rate	10.0%

For Example 19 — Alternative 2, page 1 of 2

Penny obtains the following worksheets from her tax software for her clients' second alternative ($30,000 social security benefit + $35,000 IRA withdrawal).

2011 **Federal Worksheets** **Page 1**

Client RETIRE1 **Mason and Annika Jarvis**

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IRA Distribution Schedule

Taxpayer - Payor	Total Received	Taxable Amount	Federal W/H	State W/H
	35,000.	35,000.		
Grand Total	35,000.	35,000.	0.	0.

Social Security Benefits Worksheet (Form 1040, Line 20b)

1. Social security benefits (SSA-1099, box 5)	30,000.
2. Enter one-half of line 1	15,000.
3. Add amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21 (add back excludable interest from Form 8815)	35,000.
4. Enter the amount from Form 1040, line 8b	0.
5. Add lines 2, 3 and 4	50,000.
6. Add amounts from Form 1040, lines 23 through 32, and any amount entered on the dotted line next to line 36	0.
7. Subtract line 6 from line 5 (not less than 0)	50,000.
8. Threshold for your filing status	32,000.
9. Subtract line 8 from line 7 (not less than 0)	18,000.
10. Additional threshold for your filing status	12,000.
11. Subtract line 10 from line 9 (not less than 0)	6,000.
12. Enter the smaller of line 9 or line 10	12,000.
13. Enter one-half of line 12	6,000.
14. Enter the smaller of line 2 or line 13	6,000.
15. Multiply line 11 by 85% (.85)	5,100.
16. Add lines 14 and 15	11,100.
17. Multiply line 1 by 85% (.85)	25,500.
18. Taxable social security benefits (the smaller of line 16 or line 17)	11,100.

For Example 19 — Alternative 2, page 2 of 2

2011	Federal Income Tax Summary	Page 2
Client RETIRE1	Mason and Annika Jarvis	
3/01/12		2:19 PM

INCOME	
Taxable IRA distributions	35,000
Taxable social security benefits	11,100
Total income	46,100
ADJUSTMENTS TO INCOME	
Total adjustments	0
Adjusted gross income	46,100
ITEMIZED DEDUCTIONS	
Taxes	702
Total itemized deductions	702
TAX COMPUTATION	
Standard deduction	13,900
Larger of itemized or standard deduction	13,900
Income prior to exemption deduction	32,200
Exemption deduction	7,400
Taxable income	24,800
Tax before credits	2,874
CREDITS	
Total credits	0
Tax after credits	2,874
OTHER TAXES	
Total tax	2,874
PAYMENTS	
Total payments	0
REFUND OR AMOUNT DUE	
Underpayment penalty	57
Amount you owe	2,931
TAX RATES	
Marginal tax rate	15.0%
Effective tax rate	11.6%

Penny informs Mason and Annika that taking an additional $5,000 IRA withdrawal would increase their AGI by $9,250 ($5,000 IRA withdrawal + $4,250 increase in taxable social security benefit). **This would increase their federal income taxes by $1,316, which is 26.32% of the additional IRA withdrawal of $5,000.**

After discussing their options with Penny, Mason and Annika understand that withdrawing the additional IRA funds to pay down their mortgage is not a good idea. The rate of return in the form of mortgage interest savings and any investment growth on that savings would not be high enough to offset the large additional tax increase.

Retirees who want to pass money on to their spouse, children, and/or other heirs should name these individuals as designated beneficiaries of their traditional IRAs. By doing so, beneficiaries can withdraw money from the IRAs as needed. They will have to pay federal income tax on all distributions. However, designated beneficiaries can take required minimum distributions (RMD) from the IRAs over the longer of the beneficiary's life expectancy or the deceased account owner's hypothetical life expectancy.

Note. A surviving spouse who qualifies as a designated beneficiary has other alternatives available that affect distribution amounts after the spouse's death. For detailed information about designated beneficiaries and inherited IRAs, see pages 172–178 in the 2011 *University of Illinois Federal Tax Workbook.*

Retirees who already have sufficient income may want to consider converting their traditional IRAs into Roth IRAs. The amount that is withdrawn from a traditional IRA and timely contributed (within 60 days) to a Roth IRA is called a conversion contribution. These amounts are included in taxable income for the year that they are converted. However, a taxpayer is not required to convert the entire traditional IRA at one time. Instead, the conversion of assets can be spread over several years to minimize the tax impact.

The conversion of traditional IRAs to Roth IRAs eliminates the requirement for the converted amounts to be distributed as RMDs after the taxpayer reaches age 70½. Moreover, any Roth IRA distributions received will have no impact on the taxation of social security benefits.

The account owner can pass the Roth IRA on to heirs. When this occurs, the entire interest in the Roth IRA must generally be distributed by the end of the fifth calendar year after the year of the owner's death. However, if the Roth IRA is payable to a designated beneficiary, it may be withdrawn over the life expectancy of the designated beneficiary. If the designated beneficiary's withdrawals are **qualified distributions,** the entire amount is nontaxable. A qualified distribution is a distribution that is made after the 5-year period commencing with the beginning of the first tax year in which a Roth IRA contribution was made. In addition, a qualified distribution must occur under one of the following circumstances.

- It is made on or after the date the taxpayer attains age 59½.
- It is made because the taxpayer is disabled.
- It is made to a beneficiary or estate after the taxpayer's death.
- The distribution is used to buy, build, or rebuild a first home ($10,000 limit).

Note. For more information about converting traditional IRAs to Roth IRAs, see pages 182–187 in the 2011 *University of Illinois Federal Tax Workbook* and pages 151–159 in the 2010 *University of Illinois Federal Tax Workbook.* The 2010 workbook can be found at **www.TaxSchool.illinois.edu/taxbookarchive.**

PLAN DISTRIBUTIONS: LUMP SUM VERSUS ANNUITY

Employer-sponsored retirement plans are classified as either defined contribution plans or defined benefit plans. **Defined contribution** (DC) plans allow discretionary contributions or contributions based on a formula in the plan document. In a DC plan, the participant's benefit equals the sum of employer and employee contributions, plus dividends, interest, and investment gains or losses. DC plan benefits are usually paid as lump sums to participants when they retire or quit. Employers are not required to offer participants an annuity option.

Defined benefit (DB) plans are traditional pension plans that provide participants with a specific amount of benefit that is determined by a formula, which is usually based on the participant's age at retirement, average compensation, and years of service. DB plans must offer participants the option to receive an annuity.

Most prospective retirees who have a choice between a lump-sum distribution and an annuity opt for the lump sum.[43] However, this may not be the wisest decision, especially now that provisions of the Pension Protection Act of 2006 that mandate changes in the calculation of lump sum payments have been fully phased in. This section provides relevant information that tax professionals can use in advising their clients who are facing the decision of whether to take a lump sum distribution or annuity payments.

DETERMINING THE AMOUNT OF A LUMP-SUM DISTRIBUTION

If the plan offers lump-sum distributions, the lump sum must be equivalent to the present value of the annuity to which the participant is entitled. The present value of an annuity is calculated by applying an interest rate and mortality table prescribed by the IRS. The Pension Protection Act of 2006 (PPA) modified both the mandated interest rates and mortality tables.

Beginning in 2008, plans are required to use a mortality table that reflects recent increases in life expectancy. These new life expectancy estimates increase the value of lump sums by 1–2%, depending on the participant's age.

Under previous law, DB plans were required to use the current interest rate on 30-year U.S. Treasury bonds to calculate the lump-sum value of an annuity. Under a provision in the PPA, plans are now **required** to use a corporate bond interest rate for this calculation. The present value of an annuity is inversely related to the interest rate used in the calculation—the lower the interest rate, the higher the lump sum and vice versa. The interest rate on corporate bonds has historically been higher than the interest rate on Treasury bonds of the same maturity; therefore, substituting the lower Treasury bond interest rate with a higher corporate bond rate tends to reduce lump sum payments.

The PPA required the change to the corporate bond interest rate to be phased in from 2008 to 2012, with the conversion fully effective in 2012. Plans are required to use interest rates derived from a 3-segment yield curve[44] of investment-grade corporate bonds to determine the minimum lump-sum value of an annuity. The three segments of the yield curve are determined as follows.[45]

1. The first segment is the present value of the portion of the annuity that is payable within five years. Short-term corporate interest rates are used.
2. The second segment is the portion of the annuity payable in 6–20 years. It is valued using medium-term interest rates.
3. The portion of the annuity payable in more than 20 years is valued using long-term interest rates.

The interest rates used to make the determination of this value are based on the date at which the annuity would otherwise be payable to the participant. For example, a 65-year old plan participant who is eligible for an immediate annuity would have the first five years of the annuity converted to a lump sum using the first segment of the yield curve. The 6th through 20th years would be converted to a lump sum using the rate for the second segment, and the remainder calculated using the interest rate for the third segment. In contrast, a participant in a plan that has a normal retirement age of 65 who separates from the employer at age 45 would have the present value of the entire annuity converted to a lump sum using only the third segment of the yield curve.

The PPA prohibits plans from paying lump sums that are **less** than the amounts that would result from using the corporate bond segment rates and the new mortality table.

The segment rates are available at **www.irs.gov/Retirement-Plans/Funding-Yield-Curve-Segment-Rates.**

43. An analysis by the Vanguard Center for Retirement Research revealed that 73% of traditional plan distributions and 83% of cash balance plan distributions were in the form of lump sums. [www.retirementplanblog.com/CRRLSA.pdf] Accessed on Feb. 20, 2012.

44. A yield curve is a graph that shows time periods plotted on the horizontal axis and interest rates on the vertical axis. Long-term rates are generally higher than short-term rates because the risks posed by inflation and potential of borrower default rise with the period of time over which credit is extended. Thus, yield curves generally slope upward from left to right.

45. Purcell, Patrick. Dec. 3, 2007. Congressional Research Service. [www.aging.senate.gov/crs/pension9.pdf] Accessed on Feb. 20, 2012.

TAXATION OF LUMP-SUM DISTRIBUTIONS

IRC §402(e)(4)(d) defines a lump-sum distribution as a payment of a participant's entire balance within a single tax year from all of the employer's qualified plans, which is paid to the recipient because of one of the following events.

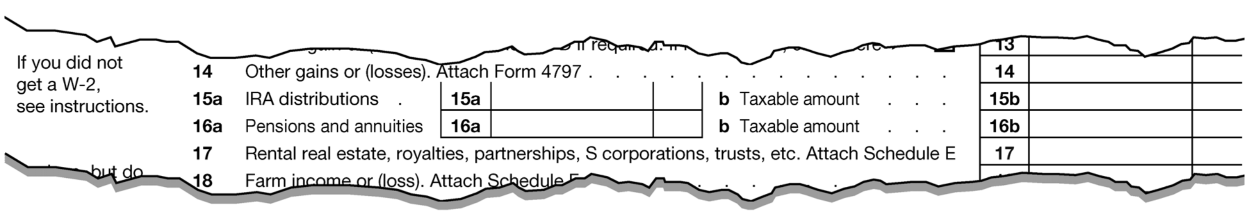
- The plan participant dies.
- The participant attains age 59½.
- The participant, if an employee, separates from service.
- The participant, if a self-employed person, becomes totally and permanently disabled.

The taxable amount of a lump-sum distribution is not always the entire amount of the distribution. The taxable portion of the distribution is calculated by subtracting the following items from the total distribution amount.[46]

- The participant's nondeductible contributions to the plan
- The participant's taxable costs of any life insurance contract distributed
- Any employer contributions that were taxable to the participant
- Repayments of any loans that were taxable to the participant
- The net unrealized appreciation (NUA) attributable to any part of the distribution that consists of the securities of the employer (The NUA distributed in a lump-sum transaction is not taxed until the shares are sold.[47])

Participant Born after 1935

Individuals born after 1935 who receive a lump-sum distribution from a qualified retirement plan must include the distribution on line 16a of Form 1040. Any portion of the lump-sum distribution that was rolled over into an IRA or an eligible retirement plan is subtracted from the amount entered on line 16b and is not currently taxable. The remainder is taxable as ordinary income.



If you did not get a W-2, see instructions.	14	Other gains or (losses). Attach Form 4797			14
	15a	IRA distributions	15a	b Taxable amount	15b
	16a	Pensions and annuities	16a	b Taxable amount	16b
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17
	18	Farm income or (loss). Attach Schedule F			

Participant Born before 1936

Individuals born before January 2, 1936, who receive a lump-sum distribution from a qualified retirement plan may be able to elect optional methods of calculating the tax on the distribution at favorable rates. The optional methods **can be elected only once after 1986** for any eligible plan participant. The following options are available to plan participants born before January 2, 1936, and their beneficiaries.[48]

1. Report the part of the distribution from participation before 1974 as a capital gain taxable at a 20% rate and the remainder of the distribution as ordinary income.
2. Report the part of the distribution from participation before 1974 as a capital gain taxable at a 20% rate and use the 10-year averaging method to calculate the tax on the remainder of the distribution.
3. Use the 10-year averaging method to calculate the tax on the total taxable amount.

46. IRS Pub. 575, *Pension and Annuity Income.*

47. IRC §402(e)(4)(A).

48. IRS Pub. 575, *Pension and Annuity Income.*

The above three options are only available if the participant was a participant in the plan for at least five years before the year of the distribution. Form 4972, *Tax on Lump-Sum Distributions,* is used to calculate the tax due.

Note. For more information about the optional methods available to certain individuals born before January 2, 1936, see IRS Pub. 575, *Pension and Annuity Income,* and the instructions for Form 4972.

TAXATION OF ANNUITY WITHDRAWALS

Fully Taxable Payments

Annuity payments are fully taxable to an individual who has no cost in the annuity contract. This applies to the following situations.[49]

- The individual did not pay anything or is not considered to have paid anything for the annuity. Amounts withheld from an employee's pay on a tax-deferred basis are not considered part of the cost of the annuity payment.
- The employer did not withhold contributions from the employee's salary.
- The individual received all of their contributions tax free in prior years.

Partly Taxable Payments

Plan participants must use the simplified method if their annuity starting date is after November 18, 1996, and they meet both of the following conditions.

1. They receive pension or annuity payments from any of the following plans.
   a. A qualified employee plan (IRC §401(a))
   b. A qualified employee annuity (IRC §403(a))
   c. A tax-sheltered annuity plan (IRC §403(b) plan)
2. At least one of the following conditions applies to the participant on the annuity starting date.
   a. They are under age 75.
   b. They are entitled to less than five years of guaranteed payments.

Under the simplified method, recipients recover their investment in the contract in equal amounts over the expected number of monthly payments determined from the tables in IRC §72(d)(1).

Example 20. Rashida, age 59, begins receiving annuity payments from her 401(k) retirement plan in 2012. She receives 12 payments totaling $15,000 during the year. Rashida invested $35,000 of nondeductible contributions in the plan. The taxable amount that Rashida received in 2012 was $13,644. This was calculated by using the following worksheet from IRS Pub. 575, *Pension and Annuity Income.*

49. Ibid.

For Example 20

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; Form 1040A, line 12a; or Form 1040NR, line 17a	**1.**	**15,000**
2.	Enter your cost in the plan (contract) at the annuity starting date plus any death benefit exclusion.* See *Cost (Investment in the Contract)*, earlier	**2.**	**35,000**
	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 (even if the amount of your pension or annuity has changed). 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.**	**310**
4.	Divide line 2 by the number on line 3	**4.**	**113**
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.**	**1,356**
6.	Enter any amounts previously recovered tax free in years after 1986. This is the amount shown on line 10 of your worksheet for last year	**6.**	**0**
7.	Subtract line 6 from line 2	**7.**	**35,000**
8.	Enter the smaller of line 5 or line 7	**8.**	**1,356**
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; Form 1040A, line 12b; or Form 1040NR, line 17b. **Note**: If your Form 1099-R shows a larger taxable amount, use the amount figured on this line instead. If you are a retired public safety officer, see *Insurance Premiums for Retired Public Safety Officers*, earlier, before entering an amount on your tax return	**9.**	**13,644**
10.	Was your annuity starting date before 1987? ☐ Yes. **STOP.** Do not complete the rest of this worksheet. ☑ No. Add lines 6 and 8. This is the amount you have recovered tax free through 2011. You will need this number if you need to fill out this worksheet next year	**10.**	**1,356**
11.	**Balance of cost to be recovered.** Subtract line 10 from line 2. If zero, you will not have to complete this worksheet next year. The payments you receive next year will generally be fully taxable	**11.**	**33,644**

* A death benefit exclusion (up to $5,000) applied to certain benefits received by employees who died before August 21, 1996.

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 over	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 over	210

Note. For a thorough discussion of annuities, see pages 495–507 in the 2010 *University of Illinois Federal Tax Workbook*. This can be found at **www.TaxSchool.illinois.edu/taxbookarchive.**

OTHER FACTORS TO CONSIDER

In addition to the tax considerations discussed in the preceding section, there are many other factors that tax professionals need to understand to help their clients make the optimal choice between a lump-sum distribution and annuity payments. Following are some of the most important factors that should be considered in making this decision.

- A lump-sum payment must be invested in order to generate lifetime retirement income. Consequently, individuals are subject to the market risks inherent with any investment.
- A retiree could take the lump sum, roll it over into an IRA, and use part of the IRA funds to buy an annuity from an insurance company. Because of competition between insurance companies, it may be possible to obtain a higher monthly payment from an insurer's annuity than is available from the company pension plan.
- The individual's life expectancy is a major consideration in deciding between an annuity and a lump sum. If the individual expects to live a long life, an annuity may be the best choice. On the other hand, if the individual's health issues, family history, and/or lifestyle indicate a likelihood of a shorter-than-average lifespan, they may be better advised to take a lump-sum distribution.
- If the financial stability of the employer is questionable, a company annuity may not be a wise choice. The annuitant depends on the company being able to make the payments many years into the future. Moreover, there have been many cases in which formerly stable companies run into financial difficulties and are no longer able to make the annuity payments.
- If a company's pension plan is significantly underfunded (liabilities exceed assets), the Pension Benefit Guarantee Corporation (PBGC) takes over the plan and pays benefits up to the guaranteed amount. The maximum monthly guaranteed amount for 2012 for a 65-year-old with a straight-life annuity is $4,653.[50] When an underfunded plan terminates, all additional benefit accruals cease. Additionally, if the plan terminates while the employer is in bankruptcy, the PBGC guarantee only covers benefits earned before the bankruptcy filing date.[51] Although the vast majority of participants in plans taken over by the PBGC face no reduction in benefits, large reductions may occur for participants who earn pensions that significantly exceed the maximum benefit.
- The PPA prohibits a DB plan from paying lump sums if the plan is less than 60% funded or if the plan sponsor is in bankruptcy and the plan is less than 100% funded.[52]
- Starting in 2012, the change in the benchmark interest rate mandated by the PPA is fully phased in, which results in lower lump-sum payouts.
- Because the actuarial tables that govern lump-sum calculations are unisex and women generally outlive men, female workers who take lump-sum payments are more likely to be shortchanged by the longevity assumptions.

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50. *Maximum Monthly Guarantee Tables.* Pension Benefit Guaranty Corporation. [www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html#2010] Accessed on Feb. 22, 2012.

51. *PBGC's Guarantees for Single-Employer Pension Plans Fact Sheet.* Pension Benefit Guaranty Corporation. [www.pbgc.gov/res/factsheets/page/guar-facts.html] Accessed on Feb. 22, 2012.

52. Purcell, Patrick. Dec. 3, 2007. Congressional Research Service. [www.aging.senate.gov/crs/pension9.pdf] Accessed on Feb. 22, 2012.

- The prospective retiree should estimate all the resources and expenses they will have in retirement. If social security benefits and other investments cover most or all of the estimated expenses, an additional annuity may not be needed. In this situation, the retiree may decide to take the lump sum and roll it into an IRA.

Caution. One factor that is often underestimated in the determination of what constitutes sufficient retirement resources is the cost of future health care. Failure to adequately plan for long-term care can overshadow all the carefully constructed parameters of preretirement calculations. For a detailed discussion of long-term care considerations, see Chapter 2 in the 2011 *University of Illinois Federal Tax Workbook.*

- Annuitants have a guaranteed income for life. Retirees who elect a joint-and-survivor annuity receive continued payments until both spouses are deceased. However, their payments are generally lower than those for a single-life annuity because of the costs associated with the joint-and-survivor option. Fixed monthly payments decline in purchasing power over time, even with a moderate inflation rate. Some pension benefits are adjusted for cost-of-living increases.

- If the retiree wants to leave money to heirs, a lump-sum payout may be the best choice.