



## Income – Retirement Income



### Introduction

This lesson will help you identify and report the taxable portion of retirement income received by the taxpayer. To do this, you must understand the types of retirement income and the forms used to report them. You should also be able to recognize when taxpayers should adjust their withholding and determine which form to use.

For more information on the topics discussed in this lesson, see Publication 575, Pension and Annuity Income; Publication 590-B, Individual Retirement Arrangements (IRAs); Publication 721, Tax Guide to U.S. Civil Service Retirement Benefits; and Publication 939, General Rule for Pensions and Annuities.

### Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify how retirement income is reported to the taxpayer using Form 1099-R series
- Calculate the taxable portion of different types of retirement income
- Determine how to report retirement income on the tax return
- Determine when an adjustment to withholding should be made

### What is retirement income?

Retirement income can include Social Security benefits as well as benefits from annuities, retirement or profit sharing plans, insurance contracts, IRAs, etc. Retirement income may be fully or partially taxable. For information about Social Security benefits and tier 1 Railroad Retirement benefits, see the Social Security Benefits lesson.

### Where can I get information about a taxpayer's retirement income?

To determine if the taxpayer must report retirement income, review the taxpayer's completed intake and interview sheet, particularly the Income section. If the taxpayer had retirement income, you may need to ask additional questions to clarify the type of plan, whether the taxpayer's contributions to the plan were before-tax or after-tax dollars, etc. This is explained later in this lesson.

Be considerate when probing for the information you need to complete the return. When taxpayers cannot provide the required information (and have not retained the packet of "retirement papers" they received when they retired), suggest that they contact their former employer or annuity administrator. You may even give the taxpayer a written list of questions that need to be resolved.

#### What do I need?

- Form 13614-C
- Publication 4012
- Publication 575
- Optional:**
- Publication 590-B
- Publication 721
- Publication 939
- Form 1040 Instructions
- Form 1040-ES
- Form 1099-R
- Form 5329
- Form 8606
- Form W-2
- Form W-4P
- Form W-4V
- Simplified Method Worksheet

## Which forms are used to report retirement income?

Retirement income can be reported on one of the forms in the Form 1099-R Series:

- Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,
- Form CSA 1099-R, Statement of Annuity Paid (civil service retirement payments),
- Form CSF 1099-R, Statement of Survivor Annuity Paid, and
- Form RRB 1099-R, Annuities or Pensions by the Railroad Retirement Board

If Form 1099-R is for an IRA-type distribution, it will be indicated in Box 7.

Examples of these forms can be found at [irs.gov](https://www.irs.gov). These forms indicate such information as the amount received, the taxable portion, and the taxpayer's cost (investment) in the plan.

If the taxable amount is indicated, volunteers with Basic certification can complete the return. In general, if the taxable amount is not indicated, volunteers with Advanced certification must calculate the taxable portion using the Simplified Method covered later in this lesson.



**CAUTION** Qualified disability income reported on Form 1099-R with a Distribution Code 3 in Box 7, is reported as earned income wages on Form 1040 until the minimum retirement age is met. Review the software entries in the Volunteer Resource Guide, Tab D, Form 1099-R Rollovers and Disability Under Minimum Retirement Age.

## What if the taxable portion is already calculated?

In many instances, the payer will compute the taxable portion of the distribution and report the taxable amount on Form 1099-R. Taxpayers with Form RRB-1099-R are in scope only for Advanced certified volunteers because the taxable portion is not shown on the form.



**Tax Software Hint:** Refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R Pension and Annuity Income.

Amounts from Form 1099-R are reported as follows:

- The gross amount (Box 1 of Forms 1099-R, CSA- and CSF-1099-R) should be shown on Form 1040 on the IRA distributions or Pensions and annuities line
- The taxable amount (Box 2a of Forms 1099-R, CSA- and CSF-1099-R) should be shown on Form 1040 on the IRA distributions or Pensions and annuities line in the taxable amount section

**Note:** The IRA/SEP/SIMPLE box is **not** checked for Roth IRAs. Instead, Roth IRAs are identified on Form 1099-R (Box 7) with a distribution code Q, J, H, or T. Only code Q is in scope for the VITA/TCE programs. In-scope Roth IRA distributions are reported on Form 1040 on the IRA distributions line.

Any amount of federal income tax withheld on Forms 1099-R, CSA- and CSF-1099-R should appear in the Federal income tax withheld from Form(s) 1099 line of the tax return.



## What if the taxable portion is not calculated?

If the payer did not include the taxable amount on Form 1099-R, CSA- or CSF-1099-R, or if taxpayers have Form RRB 1099-R, you will need to compute the taxable portion of the distribution. The following will help you determine the additional information needed to calculate the taxable portion of distributions from IRAs, pensions, or annuities.

## What do I need to know about retirement income distributions?

Retirement plans are funded by either before-tax or after-tax contributions. “Before-tax” simply means that the employee did not pay taxes on the money at the time it was contributed, i.e., the taxpayer has no cost basis in the plan. “After-tax” means the employee paid taxes on the money when it was contributed, i.e., the taxpayer *has* a cost basis in the plan.

If the taxpayer made all contributions to a plan with before-tax dollars, the entire distribution will be fully taxable. The funds are taxed at the time of the distribution because neither the contributions nor the earnings/investment gains were previously taxed. This is common in 401(k) and Thrift Savings Plans.



If the taxpayer did *not* contribute to the retirement plan, all the distributions are fully taxable.

If the taxpayer made contributions to a plan with after-tax dollars, then the distributions will be partially taxable. The portion of the distribution that is considered a return of the after-tax dollars will not be taxed again. It is considered a return of the taxpayer’s cost basis (an amount for which taxes have already been paid). The portion of the distribution that represents the earnings/investment gains is taxable since it has not been previously taxed. This is common in employer retirement plans. Qualified distributions from an employer plan designated Roth account are wholly nontaxable, similar to a Roth IRA.

Employee Contributions	Contributions		Taxability of Distributions		
	Before-Tax	After-Tax	Fully	Partially	Nontaxable
No	n/a	n/a	Yes	—	—
Yes	Yes	—	Yes	—	—
Yes	—	Yes	—	Yes	—
Yes, Roth	—	Yes	—	—	Yes

### example

Mark retired after working 30 years for a construction company. Each week, he contributed to the Carpenter’s Pension Plan. Every year, Mark paid tax on the gross amount of his salary, including his pension contribution. This means his pension contributions were made with dollars that had already been taxed. Now that he is receiving payments from the pension, he will not be taxed on the portion that represents his contribution; he *will* be taxed on the portion that represents earnings.



Taxpayers may not always understand why they must pay taxes on their retirement income. When this is the case, take the time to clearly explain what retirement funds are taxed and why. It is usually a good idea to question taxpayers about the nature of their contributions to ensure that they will not be taxed twice on the same funds.

## How do I find the taxable portion of IRA income?

### Individual Retirement Arrangements

IRA distributions are reported on Form 1099-R. Earnings and investment gains in a taxpayer's IRA generally accumulate tax free or tax deferred until they are withdrawn as fully or partially taxable distributions. There are four kinds of IRAs, each with different tax implications:

- Traditional IRA
- Roth IRA
- Savings Incentive Match Plans for Employees (SIMPLE) IRA
- Simplified Employee Pension (SEP) IRA

#### **Traditional IRA**

Distributions from traditional IRAs are fully taxable unless nondeductible contributions have been made. See the Adjustments lesson for additional information. Form 8606, Nondeductible IRAs, is used to keep track of nondeductible contributions. Taxpayers who made nondeductible contributions should be referred to a professional tax preparer.



When you learn about IRA accounts in the Adjustments to Income lesson, be sure to note the difference between "contributions" and "deductions." Simply put, contributions are the amounts deposited into an IRA account, and deductions are the portion of the contribution that is deducted on the tax return. The deductible portion may be less than the amount allowed as a contribution.

#### example

Richard contributed \$500 a year to a traditional IRA. Each year, he deducted these contributions from his income. This year he received his first distribution from the traditional IRA. It is fully taxable: Richard will pay income tax on the distributions he receives, which represent the contributions he made and deducted, as well as the earnings on these contributions over the years.

#### **Roth IRA**

Qualified distributions from a Roth IRA are tax free and may be excluded from income. The IRA trustee will indicate the distribution is qualified by using Code Q in Box 7 if the following requirements are met:

- The distribution is made after the 5-year period beginning with the first day of the first taxable year for which a contribution was made to a Roth IRA set up for the taxpayer's benefit, *and*
- The distribution is:
  - Made on or after age 59½, or
  - Made because the taxpayer was disabled, or
  - Made to a beneficiary or to an estate, or
  - To pay certain qualified first-time homebuyer amounts (up to a \$10,000 lifetime limit)



The 5-year rule applies to each Roth conversion and rollover. See Publication 590-B.



You can identify Roth IRAs from the distribution code used on Form 1099-R. Distribution codes Q, J, H, and T are specific to Roth IRAs. **Only code Q is in scope for the VITA/TCE programs.** See instructions for code Q in the Volunteer Resource Guide, Tab D, Income. For rules on converted Roth IRAs, see Publication 590-B.

### **Nonqualified Distributions**

If the above requirements are not met, the distribution is nonqualified and additional taxes may apply. Taxpayers who made nonqualified Roth IRA distributions should be referred to a professional tax preparer.

### **Savings Incentive Match Plans for Employees (SIMPLE) IRA**

Some employers offer their employees (including self-employed individuals) the chance to contribute part of their pay to an IRA as part of a SIMPLE plan. The employer is also generally required to make contributions on behalf of eligible employees. Generally, SIMPLE IRA contributions are not included in an employee's income when paid into an IRA, and the distributions are fully taxable when the employee receives them in later years.

### **Simplified Employee Pension (SEP) IRA**

Some employers offer their employees (including self-employed individuals) the chance to contribute part of their pay to an IRA as part of a SEP plan. Generally, SEP IRA contributions are not included in an employee's income when paid into the IRA. Because of this, distributions are generally fully taxable when the employee receives them in later years.



### **EXERCISES**

Answers follow the lesson summary.

**Question 1:** Distributions from all IRAs discussed in this topic are fully taxable with the exception of the Roth IRA.  True  False

**Question 2:** Mary opened a Roth IRA 3 years ago. This year, she took the full amount of her Roth IRA as a distribution to help her purchase her first home. The entire distribution is excluded from her taxable income.  True  False

**Question 3:** Amy contributed to a Roth IRA for 5 years. In year 6 (at age 60), she took a distribution from her IRA. The entire distribution is excluded from her taxable income.  
 True  False

## **How are IRA distributions reported?**

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### **Traditional IRA**

If IRA/SEP/SIMPLE is checked on Form 1099-R, ask the taxpayer:

- Was this a distribution from a traditional IRA?
- Were the contributions deducted from income in the year they were made?

If so, the entire distribution is taxable. Report the distributions on Form 1040. If not, the distribution is partially taxable and Form 8606 is required. In that case, the return is out of scope.



An early distribution from a traditional or Roth IRA may be subject to a 10% additional tax. Refer to the Other Taxes lesson for more information.

## ***SIMPLE and SEP IRAs***

Distributions from SIMPLE and SEP IRAs are in scope for VITA/TCE, because they are taxable and are generally reported on the return just like taxable traditional IRA distributions.

Exception: Funds distributed from a SIMPLE IRA in the first two years are subject to a 25% early distribution penalty. If this is applicable, Form 1099-R will be issued with distribution code S. If an exception to the penalty applies, complete Form 5329 as you would do with traditional IRA distributions.

## ***Roth IRA***

Distributions from a Roth IRA are not taxable as long as they meet all the criteria discussed previously. If the distribution does not meet the criteria, then all or part of the funds **MAY** be taxable; refer the taxpayer to a professional tax preparer.

## **How are rollovers handled?**

Generally, a rollover is a tax-free distribution to the taxpayer from one retirement account (traditional IRA or employer's pension plan) that rolls over into another qualified retirement account within 60 days.

Form 1099-R will be issued to the taxpayer by the financial institution. If the distribution was a direct rollover by the institution to another institution, it will show distribution code G. If there is also a taxable amount in Box 2 of the 1099-R, the distribution may be partially or fully taxable.

If the taxpayer indicates that a rollover occurred but the distribution code is NOT G, then the taxpayer must have re-deposited the full amount into an appropriate account within 60 days. If this was not done, the distribution may be partially or fully taxable; refer the taxpayer to a professional tax preparer unless the self-certification procedure applies.

**Note:** Distributions from SIMPLE IRAs in the first two years (distribution code S) can only be rolled over tax-free into other SIMPLE IRAs. Taxable SIMPLE IRA rollovers are out of scope for VITA/TCE.



**CAUTION** There is a limit of one IRA rollover per twelve months. This does not affect the ability of an IRA owner to transfer funds from one IRA trustee directly to another because such a transfer is not a rollover.

## **What about a rollover from a Roth IRA?**

Most of the rules for rollovers to traditional IRAs apply to Roth IRAs. Generally, a withdrawal of all or part of the assets from one Roth IRA and a contribution to another Roth IRA within 60 days is tax free. A rollover from a Roth IRA to an employer retirement plan is not allowed.

If there is a direct rollover of a designated Roth account distribution to a Roth IRA, the distribution code for Form 1099-R will be code H. If the distribution does not meet the tax-free rollover requirements, all or part may be taxable; refer the taxpayer to a professional tax preparer.

A conversion of a traditional IRA to a Roth IRA, and a rollover from any other eligible retirement plan to a Roth IRA, made after December 31, 2017, cannot be recharacterized as having been made to a traditional IRA.



**Tax Software Hint:** Additional information must be entered for retirement account rollovers. Refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R.



**TIP** A qualified plan loan offset distribution (Code M in Form 1099-R, box 7) is due to plan termination or severance from employment. Instead of the usual 60-day rollover period, the taxpayer has until the due date, including extensions, for filing the Federal income tax return for the taxable year in which the offset occurs to complete the rollover.



## EXERCISES (continued)

**Question 4:** Andrew changed jobs and received Form 1099-R from his previous employer. The gross distribution amount in Box 1 is \$11,200. Andrew deposited the entire \$11,200 into his IRA within 30 days of receiving the check (rollover).

Which of the following statements is true?

- A. The entire distribution is includible as income
- B. The entire distribution is excludable from income
- C. The distribution is eligible for the ten-year tax option
- D. The distribution is eligible to be taxed at a special rate

## What is the IRA self-certification procedure?

### Procedure Helps People Making Retirement Plan Rollovers

**Revenue Procedure 2016-47** explains a self-certification procedure designed to help recipients of retirement plan distributions who inadvertently miss the 60-day time limit for properly rolling these amounts into another retirement plan or individual retirement arrangement (IRA). Eligible taxpayers can qualify for a waiver of the 60-day time limit and avoid possible taxes and penalties on early distributions, if they meet certain circumstances. Taxpayers who missed the time limit will ordinarily qualify for a waiver if one or more of 11 circumstances, listed in the revenue procedure, apply:

- An error was committed by the financial institution making the distribution or receiving the contribution.
- The distribution was in the form of a check and the check was misplaced and never cashed.
- The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was a retirement plan or IRA.
- Taxpayer's principal residence was severely damaged.
- One of the taxpayer's family members died.
- Taxpayer or a family member was seriously ill.
- Taxpayer was incarcerated.
- Restrictions were imposed by a foreign country.
- A postal error occurred.
- The distribution was made on account of an IRS levy and the proceeds of the levy have been returned.
- The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite reasonable efforts to obtain the information.
- The distribution was made to a state unclaimed property fund (Revenue Procedure 2020-46).



Ordinarily, the IRS, plan administrators, and trustees will honor a taxpayer's truthful self-certification that they qualify for a waiver under these 11 circumstances. Even if a taxpayer does not self-certify, the IRS now has the authority to grant a waiver during a subsequent examination. Other requirements, along with a copy of a sample self-certification letter, can be found in the revenue procedure.

The IRS encourages eligible taxpayers wishing to transfer retirement plan or IRA distributions to another retirement plan or IRA to consider requesting that the administrator or trustee make a direct trustee-to-trustee transfer, rather than doing a rollover. Doing so can avoid some of the delays and restrictions that often arise during the rollover process.

For more information, refer to Publication 590-A, Contributions to Individual Retirement Arrangements (IRAs).

## Qualified Charitable Distributions

A qualified charitable distribution (QCD) is generally a nontaxable distribution made directly by the trustee of the IRA to an organization eligible to receive tax-deductible contributions. The taxpayer must be at least age 70½ when the distribution is made. In accordance to Setting Every Community Up for Retirement Enhancement (SECURE) Act, the long-standing 70½ age limit for making contributions to traditional IRAs was eliminated for tax years beginning after 2019. In addition, the excludible portion of a QCD distribution is reduced by IRA deductions once the taxpayer attains age 70½. The taxpayer must have the same type of acknowledgement of the contribution that is needed to claim a deduction for a charitable contribution. Typically, a QCD counts towards the taxpayer's required minimum distribution (RMD).

The maximum annual exclusion for QCDs is \$100,000. Any QCD in excess of the \$100,000 exclusion limit is included in income as any other distribution. On a joint return, the spouse can also have a QCD and exclude up to \$100,000.



If a QCD is reduced by an IRA contribution, the taxpayer will show that amount as a taxable distribution. Additionally, the taxpayer may claim a charitable contribution deduction for the donation.

## How do I find the taxable portion of pensions and annuities?

### Fully Taxable Pensions and Annuities

Pension and annuity income is reported on Form 1099-R, Form CSA 1099-R, and Form RRB 1099-R. In general, pension or annuity payments are fully taxable, if the following is true:

- Taxpayers did not pay any part of the cost of their pensions or annuities
- Employers did not withhold part of the cost from the taxpayers' pay while they worked
- Employers withheld part of the cost from the taxpayer's before-tax pay while they worked



Social Security benefits are not reported on the pension line of the tax return. Social Security income is covered in a later lesson.

#### example

Sue worked for a software development company for 20 years. She retired and began receiving pension income the same year. Sue never contributed to the pension plan while she was working; her employer made all of the contributions. Her pension is fully taxable.

### Partially Taxable Pensions and Annuities

Two methods used to figure the taxable portion of each pension or annuity payment are the General Rule and the Simplified Method. Unless an exception applies, retirees must use the Simplified Method for annuity payments from a qualified plan. A qualified plan is established by an employer to provide retirement benefits for employees and their beneficiaries. Employees typically do not pay taxes on plan assets until the assets are distributed; furthermore, earnings on qualified plans are tax deferred. If a taxpayer tells you they have been using the General Rule to figure the taxable portion for past years, refer them to a professional tax preparer.



If the taxpayer's annuity starting date is before July 2, 1986, the General Rule has to be used unless the Three-Year Rule was used.



The Simplified Method is used to calculate the tax-free portion of each pension or annuity payment. The Simplified Method Worksheet calculates the taxpayer's cost basis for each monthly payment. The number of monthly payments is based on the taxpayer's age (and the spouse's age if a joint/survivor annuity is selected by the taxpayer) on the annuity start date. This calculation is not changed for subsequent events, such as divorce, marriage or death.

Taxpayer's cost basis ÷ Number of monthly payments = Monthly Tax-Free Portion

**example**

Joe elected a joint/survivor annuity when he retired and started receiving his pension on July 1, 2015. Joe was born March 5, 1950 and his wife, Mary, was born on July 23, 1953. Here is how they compute their combined ages for the Simplified Method.

	<b>Joe</b>	<b>Mary</b>	<b>Combined</b>
Date born	3/5/1950	7/23/1953	
Date annuity started	7/1/2015	7/1/2015	
Age when annuity started	65	61	126

**Note:** Mary had not reached her 62nd birthdate by the day the annuity started.



**CAUTION** To ensure the taxable portion of the pension is calculated correctly, the age of the taxpayer(s) at the annuity start date, not their age for the tax year, must be used when determining the total number of expected monthly payments.



**Tax Software Hint:** Refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R for more information on calculating the taxable portion using the Simplified Method.

Be sure to include any amount of federal income tax withheld on Form 1099-R in the Federal income tax withheld from Forms W-2 and 1099 line of the tax return.

To calculate the taxable portion of a pension or annuity using the Simplified Method, you will need certain information:

- The cost in the plan (total employee contribution on Form 1099-R)
- The taxpayer's age on the date the annuity began (and the spouse's age if joint/survivor annuity is selected); note if the annuity starting date is before or after the taxpayer's birthday for that year
- Total of tax-free amounts from previous years, available from the taxpayer's prior year worksheet

If the taxpayer has more than one Form 1099-R that is not fully taxable, calculate the tax-free portion for each form separately.

**example**

Melvin retired from a manufacturing plant. While he was working at the plant, his employer withheld money from each paycheck and sent it to the Engineer's Pension Fund. Melvin will receive a monthly pension payment for the rest of his life. Melvin will use the Simplified Method Worksheet to determine the tax-free part of monthly payments.



## EXERCISES (continued)

**Question 5:** Dotty worked for the local tire plant for 32 years. She retired in June and receives a monthly pension of \$1,679. (She received six payments for July through December.) Dotty never contributed to the pension plan; her employer made all of the contributions. How much of her pension is taxable?

- A. \$12,074
- B. \$11,074
- C. \$10,074
- D. \$1,679

### Disability Pension Income

Generally, taxpayers who retire on disability must include all of their disability payments in income.

**Disability payments are taxed as wages until the taxpayer reaches the minimum retirement age – this age is set by the employer.** After the taxpayer reaches the minimum retirement age, disability payments are treated as pension income to determine taxability.



Taxpayers are considered disabled if they cannot engage in any substantial gainful activity because of any medically determinable physical or mental condition that can be expected to result in death or to be of long-continued and indefinite duration.

Minimum retirement age is generally the earliest age at which taxpayers may receive a pension, whether or not they are disabled.

Employers may report disability income on one of the following forms:

- Form W-2, if the taxpayer has not reached the minimum retirement age set by the employer
- Form 1099-R, if the taxpayer has reached the minimum retirement age



Some employers report qualified disability income on Form 1099-R with Distribution Code 3 in Box 7 regardless of the taxpayer's age. **You must confirm the employers' minimum retirement age.** If the taxpayer is under the retirement age, the volunteer must take steps in the software to ensure the income is properly reflected as **wages** on Form 1040. When disability pay is treated as wages, it might affect the earned income credit and the taxpayer's ability to make an IRA contribution.



**Tax Software Hint:** If Form 1099-R, Box 7, indicates a distribution code 3, and the taxpayer is on disability but under retirement age, check the box stating the taxpayer is disabled. The tax software will place the amount on Form 1040 as wages, rather than on the pension line.

Refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R for more information on how to report disability pay to ensure it is reported on the correct line of Form 1040.



## EXERCISES (continued)

**Question 6:** Annie Jo is 47 years old and has retired on disability from her job. While loading cargo for a tractor-trailer company, a large box fell on her and left her paralyzed. She receives a monthly payment from her former employer's pension plan to which Annie Jo had not contributed. She has not reached the minimum retirement age set by her company's pension plan. How should she report her disability income on her Form 1040?

- A. Estimated tax payments and amount applied from return
- B. Pensions and annuities
- C. Taxable pensions and annuities
- D. Wages

### Retired Public Safety Officers

Eligible public safety officers can elect to exclude from income distributions of up to \$3,000 made directly from a government retirement plan to the provider of accident, health, or long-term disability insurance. A public safety officer includes a law enforcement officer, firefighter, chaplain, or member of a rescue squad or ambulance crew. See Insurance Premiums for Retired Public Safety Officers in Publication 575, Pension and Annuity Income, for more information.



**Tax Software Hint:** If the taxpayer is eligible for the exclusion, refer to the Volunteer Resource Guide, Tab D, Income, Form 1099-R.

### What other retirement income issues are there?

There are a few other issues related to reporting retirement income that you may encounter. Some of the following distributions are subject to various additional taxes that are computed on Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. If certain exceptions are met, the additional tax does not apply.

Only the exceptions for early distributions not subject to the additional tax (Part I of Form 5329) are included in scope for the VITA/TCE training. Refer taxpayers who must complete other information on Form 5329 to a professional tax preparer. Form 5329 and exceptions are covered in the Other Taxes lesson.

### Lump-Sum Distributions

A lump-sum distribution is the distribution or payment within one tax year of an employee's entire balance from all qualified pension, stock bonus, or profit-sharing plans that the employer maintains. The distribution does not include certain deductible voluntary employee contributions and certain amounts forfeited or subject to forfeiture. Distributions from IRAs or tax-sheltered annuities do not qualify as lump-sum distributions.

To qualify as a lump-sum distribution, the plan participant must have been born before January 2, 1936 and the payment must have been made:

- Because the plan participant died, or
- After the participant reached age 59½, or
- Because the participant (not including a self-employed individual) separated from service with the employer, or
- After the participant, if self-employed, became totally and permanently disabled

Lump-sum distributions are reported on Form 1099-R like any other pension distribution. Some lump-sum distributions qualify for special tax treatments. If Form 1099-R indicates a distribution code of A, it is a lump-sum distribution qualifying for special tax treatments. Taxpayers with this situation should be referred to a professional tax preparer.

## Early Distributions

An early distribution is a withdrawal from a retirement fund by a taxpayer who is under age 59½. Early distributions can be subject to an additional 10% tax. The additional tax applies to the taxable portion of the distribution or payment.

Certain early distributions are not subject to the early distribution tax. When the distribution code on Form 1099-R is 1, the taxpayer will not be subject to the additional 10% tax if an exception applies.

If the distribution code is 2, 3, or 4, the taxpayer does not have to pay the additional tax. The exceptions for excluding early distributions, from the additional tax are covered in more detail in the Other Taxes lesson.

## Minimum Distributions

To avoid an additional tax for excess accumulation, participants in retirement plans must begin taking a Required Minimum Distribution (RMD) by a specified date. That date is April 1 of the calendar year following the year in which the taxpayers either reached age 72 (70½ if the taxpayer reaches 70½ before January 1, 2020), or retired, whichever is later. For IRAs, it does not matter whether the taxpayer has retired. These rules do not apply to Roth IRAs. The trustee of the qualified plan will contact the taxpayer at the appropriate time to begin their RMD.

After the starting year for RMDs, taxpayers must receive the minimum distribution for each year by December 31 of that year. (The starting year is the year in which the taxpayer reaches 72, 70½ before January 1, 2020, or retires.) If no distribution is received during the taxpayer's starting year, the required minimum distributions for two years must be received the following year, one of which must be taken by April 1.

If a taxpayer's 70th birthday is July 1, 2019 or later, the taxpayer does not have to take withdrawals until reaching age 72. For those who were age 70½ or younger on Jan. 1, 2020, their first RMD is not due until April 1 of the year after they turn age 72. For example, for those who turn 72 on July 1, 2021, they must take their first RMD (for 2021) by April 1, 2022, and their second RMD (for 2022) by December 31, 2022.



The RMD rules for inherited retirement accounts depend on the relationship and age of the beneficiary and are beyond the scope of the VITA/TCE programs. Refer taxpayers to their trustee if they have questions.



If the taxpayer does not receive the minimum distribution, an additional tax may be imposed. The tax is 50% of the difference between the minimum distribution and the amount actually distributed for the tax year. Taxpayers may request a waiver of the 50% additional tax using Form 5329, Part IX, which is out of scope for the VITA/TCE program. Refer affected taxpayers to a professional preparer.

### example

Peter turned 70½ on August 20, 2018. He must receive the first required minimum distribution from his IRA by April 1, 2019. He must receive a second required minimum distribution by December 31, 2019.

**example**

Ralph retired five years ago. He turned 70½ on March 15, 2020. He must begin taking minimum distributions from his qualified plans by April 1 following the year he turns 72.

**example**

Myrna was 72 when she retired in 2018. She was required to begin taking minimum distributions from her traditional IRA by April 1 of the year following the year she turned 70½ even though she had not retired. Myrna had to take a second required distribution by December 31 of the same year.

This information is provided for your information only, to help you answer any questions a taxpayer may ask about RMD. RMD distributions are reported on Form 1099-R and included on the return using the procedures previously discussed.

### **Withdrawal of Excess IRA Contributions**

An excess IRA contribution is the amount contributed to a traditional and/or Roth IRA during the year that is more than the smaller of the:

- Maximum IRA amount for the year based on the taxpayer's age, or
- Taxable compensation for the year

The taxpayer may not know that a contribution is excess until the tax return is completed after the end of the year. In this situation, the excess amount, with any earnings on that amount, must be withdrawn by the due date of the return (including extensions). If the excess amount is not withdrawn by the due date of the return, the taxpayer will be subject to an additional 6% tax on this amount, and the return is out of scope .

The withdrawn excess contribution is not included in the taxpayer's gross income if both of the following conditions are met:

- No deduction was allowed for the excess contribution
- All interest or other income earned on the excess contribution is withdrawn by the due date of the return, including extensions

However, taxpayers must include the earnings on the excess contribution as income on the return. This income is reported on the return for the year in which the excess contribution was made. The withdrawal of interest or other income may also be subject to an additional 10% tax on early distributions.

If the taxpayer is subject to an additional tax due to excess IRA contributions, refer them to professional tax preparer.



### **EXERCISES** (continued)

**Question 7:** Taxpayers who withdraw excess contributions and earnings on the excess contributions by the due date of the tax return are not subject to an additional 6% tax on the excess contribution.

True    False

**Question 8:** Helen turned 70½ on March 17, 2020. She retired in 2013. She has never taken any distribution from her traditional IRA accounts. Helen is required to:

- A. Take a distribution by December 31, 2020.
- B. Take a distribution by April 1, 2021.
- C. Take a distribution by December 31, 2021.
- D. Take a distribution by April 1, 2022, and another by December 31, 2022.



## What retirement distributions qualify for tax-favorable treatment?

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### Special Provisions and Tax-Favorable Treatment of Retirement Fund Distributions

The CARES Act of 2020 provided for three special rules for up to \$100,000 of coronavirus-related distributions from eligible retirement plans to qualified individuals for 2020: exception to the additional tax on early distributions; distributions may be included in income over a 3-year period; and, to the extent the distribution is eligible for tax-free rollover treatment, the distribution may be recontributed. If the retirement distribution recipient is not a qualified individual, none of these provisions apply. For 2021, the three-year spread and permitted recontributions need to be reported on Form 8915-F.

### What are the rules for the 3-year spread of eligible distributions?

A taxpayer who elected to include designated coronavirus-related distributions in income ratably over a 3-year period needed to file Form 8915-E with their 2020 tax return. For a 2020 designated coronavirus-related distribution received on or after January 1, 2020, and before December 31, 2020, the taxpayer will report the taxable distribution equally, 1/3 in each year 2020, 2021, and 2022. The election to opt out of the 3-year spread provision cannot be made or changed after the timely filing of the return (including extensions) for the year of the distribution.

### What are the rules for recontributions of eligible distributions?

A qualified individual may recontribute part or all of their eligible designated coronavirus-related distributions to an eligible retirement plan (up to an aggregate limit of \$100,000), but not an amount in excess of the amount of the distribution. Recontribution is permitted whether or not the 3-year spread is elected. The recontribution must be completed within three years beginning with the day after the date that the distribution was received.

Not all coronavirus-related distributions may be repaid. That is, a distribution that is eligible for the 3-year spread may or may not be eligible for recontribution. In general, distributions that would be eligible for tax-free rollover treatment are eligible for recontribution under the CARES Act. The following distributions are not eligible for recontribution:

1. Any coronavirus-related distribution (whether from an employer retirement plan or an IRA) paid to a qualified individual as a beneficiary of an employee or IRA owner (other than the surviving spouse of the employee or IRA owner).
2. Any distribution (other than from an IRA) that is one of a series of substantially equal periodic payments made (at least annually) for:
  - a. A period of 10 years or more,
  - b. The individual's life or life expectancy, or
  - c. The joint lives or joint life expectancies of the individual and the individual's beneficiary.

**TIP**

A pension is a periodic payment and cannot be repaid, even if the taxpayer elects to use the 3-year spread of the income.

The recontribution can be made to any qualified account that will accept the recontribution. In general, it is anticipated that eligible retirement plans will accept recontributions of coronavirus-related distributions, which are to be treated as rollover contributions. However, a recontribution under this CARES Act provision will not be treated as a rollover contribution for the one-in-12-months limitation.

### example

Claudia is a qualified individual who received an eligible coronavirus-related distribution from her employer's 401(k) plan. She can choose to recontribute the distribution to her employer's plan, if the plan allows, or to recontribute the distribution to her IRA. The employer plan administrator or IRA trustee may request that Claudia certify she satisfies the recontribution requirements.

### How are these provisions reported on a tax return?

A qualified individual will include Form 8915-E in their timely filed 2020 tax return and report:

- All their distributions and their designated coronavirus-related distributions,
- Whether they opt out of the 3-year spread for their eligible distributions,
- The amount of qualified repayments made before filing their 2020 return (but not later than the due date of the return, including extensions), and
- The amount of their designated coronavirus-related distributions taxable in 2020.

Form 8915-F will be filed for 2021 and/or 2022 and/or 2023 to report the amount of the eligible distribution that has been repaid for the year, if any, and the taxable amount of their designated coronavirus-related distributions if the 3-year spread was elected. A repayment is applied to the current tax year's ratable amount (if any) of taxable distribution first.

If the repayment exceeds the current tax year's ratable taxable amount (if any), the taxpayer can elect to either carry back or carry forward the excess. A qualified individual who repays some or all of a distribution that has been included in taxable income in a prior year will need to file an amended return with an amended Form 8915-E or 8915-F for that prior year to receive a refund of tax they paid. A repayment made by the due date of the return (including extensions), or the actual date of filing if earlier, is applied to that tax year.

### Taxpayer Interview and Tax Law Application

#### SAMPLE INTERVIEW

VOLUNTEER SAYS...

JAMES RESPONDS...

*I see in your 2020 return that you elected to spread your retirement distribution over three years.*

Yes, I had to take extra money out of my IRA. Being able to spread the tax seemed like a good idea.

*Form 8915-E shows the amount of distribution of \$45,000. Is that right? Which means \$15,000 will be taxable in 2021.*

Yes, that's right.

*You also have the ability to repay or recontribute some or all of the distribution. If you do so, you can reduce the amount taxable in 2021 for any repayments made after you filed your 2020 return up through the day you file your 2021 return. Did you make any recontributions during that time or do you plan to do so before we file your 2021 return?*

I would like to, but cash is a little tight right now. Can I recontribute it next year?

*Yes. You have until three years from the day after the date you took the money out of your IRA. If you recontribute more than the 1/3 that is taxable for that year, an amended return may be needed as the excess can be carried back to a year already filed*

Ok. Sounds good. I'll double check the date I took the distribution and keep track of any recontributions I make.

### example

Adrian took an eligible coronavirus-related distribution of \$60,000 on September 1, 2020. He uses the ratable income inclusion method for the distribution (\$20,000 included in income on each federal income tax return for 2020, 2021, and 2022). He repaid \$15,000 to his IRA on March 15, 2022 before filing his 2021 return. The \$15,000 recontribution is applied to 2021 and Adrian includes the remaining \$5,000 in income in 2021.

If Adrian filed his 2021 return on March 1, 2022, before making the recontribution, the \$15,000 recontribution would be applied to the ratable taxable amount for his 2022 tax year first.

### example

LaDonna is a qualified individual who includes a \$45,000 IRA coronavirus-related distribution she took in 2020 in income ratably over a 3-year period. She includes \$15,000 in income in 2020. LaDonna recontributes \$20,000 to her IRA in 2021 after filing her 2020 tax return. None of the ratable taxable amount will be taxable in 2021 (the ratable taxable amount of \$15,000 is fully offset by the \$20,000 recontribution and there is an excess recontribution of \$5,000). LaDonna can choose to either carry forward the \$5,000 excess recontribution to reduce the ratable taxable amount for 2022 or to apply it to 2020 by filing an amended return to revise the ratable taxable amount in 2020 downward to \$10,000.

## What is not in scope?

Disaster-related distributions that are not coronavirus-related distribution are out of scope. For more information, refer to:

- Disaster Assistance and Emergency Relief for Individuals and Businesses at: (<https://www.irs.gov/businesses/small-businesses-self-employed/disaster-assistance-and-emergency-relief-for-individuals-and-businesses>)
- Publication 5396, Fact Sheet for VITA/TCE Sites Impacted by Federally Declared Disasters (January 1, 2018 – December 20, 2019) (<https://www.irs.gov/pub/irs-pdf/p5396.pdf>)
- Publication 5396-A, Job Aid for VITA/TCE Volunteers: Using Form 4852 when Missing the Form W-2 or 1099-R (<https://www.irs.gov/pub/irs-pdf/p5396a.pdf>)
- Publication 5396-B, Tax Counseling for the Elderly Casualty Loss Screening Tool (<https://www.irs.gov/pub/irs-pdf/p5396b.pdf>)



## How do I determine when an adjustment to withholding should be made?

After the completion of the return, if the taxpayer owes \$1,000 or more on the tax return, you should discuss their withholding and estimated tax options with them. This is covered in more detail in the Completing the Return lesson.

Sometimes taxpayers are not aware they can request that federal income tax be withheld from their retirement income by filing Form W-4P, Withholding Certificate for Periodic Pension or Annuity Payments or Form W-4R, Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions. This form is sent to the payer. Also, Form W-4V, Voluntary Withholding Request, is used to request withholding from Social Security benefits. This form is sent to the Social Security Administration. Every year, the Social Security Administration reports taxpayers' retirement benefits and/or voluntary withholdings on Form 1099-SSA.





Taxpayers who receive a very large refund may make better use of their funds if tax withholding is lowered. Explain ways they can reduce their withholding.

For additional help, taxpayers can refer to Publication 17, Withholding, Form W-4, or visit the IRS website and use the “Tax Withholding Estimator.” A taxpayer who chooses not to have tax withheld may have to pay estimated tax each quarter. Failure to pay enough federal income tax throughout the year can result in a large amount of tax being owed when the return is due. It can also result in a penalty. Form 1040-ES, Estimated Tax for Individuals, is used to calculate the estimated quarterly payment and provides vouchers with which to remit the payments.



## EXERCISES (continued)

**Question 9:** Faith comes to your site to get her tax return done. When you finish her return, you explain to her that she owes \$985, and that she needs to pay this amount by the due date. She says that she will pay the amount, but wants to know if there is some way to have more tax withheld from her pension so that she doesn't owe so much at the end of the year. Which form should she complete to increase the withholding from her pension?

- A. Form W-4P
- B. Form W-4V
- C. Form W-4R

## Summary

This lesson helped you identify, calculate, and report the taxable portion of retirement income received by the taxpayer. It reviewed the types of retirement income and the forms used to report them. You learned when taxpayers of retirement age are required to take a minimum distribution from a retirement plan and when they may need to adjust their withholding.

### What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- The taxpayer needs to file Form 8606
- Taxpayers who made nondeductible contributions to a traditional IRA
- Taxpayers subject to additional tax due to excess IRA contributions
- Roth IRA distributions that are taxable or partially taxable, and distributions with Form 1099-R, code J or T
- IRA rollovers that do not meet the tax-free requirements
- Taxpayers who used the General Rule to figure the taxable portion of pensions and/or annuities for past years
- Form 1099-R, distribution code A (lump-sum distribution qualifying for special tax treatments)



## TAX LAW APPLICATION

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons in the training. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you cover all the technical topics.



## EXERCISE ANSWERS

**Answer 1:** *False. In addition to Roth IRAs, nondeductible contributions to traditional IRAs are also not taxed when they are distributed.*

**Answer 2:** *False. Mary's distribution was not made after the 5-year period beginning with the first taxable year she made a contribution to her Roth IRA. Therefore, the earnings/investment gains portion of the distribution will be taxable income. (She may also owe an additional tax on early distributions. This will be discussed in the Other Taxes lesson.)*

**Answer 3:** *True. Amy's distribution can be excluded from her taxable income because it was made more than five years after the beginning of the taxable year of her first contribution, and it was made on or after age 59½.*

**Answer 4:** *B. Andrew can exclude the entire distribution from income because it was rolled over into an IRA within the allowed 60-day period.*

**Answer 5:** *C. Dotty's entire pension amount of \$10,074 (6 x \$1,679) is fully taxable because she has never paid income taxes on her employer's contribution to her pension.*

**Answer 6:** *D. Because Annie Jo has not reached the minimum retirement age set by her employer, you should report her disability income as wages on her Form 1040.*

**Answer 7:** *True. Taxpayers must withdraw excess contributions and any earnings by the due date of the return (including extensions) to avoid the additional 6% tax on the excess contribution.*

**Answer 8:** *D. Taxpayers are required to begin receiving distributions from their qualified plan by April 1 of the calendar year following the year in which they reach age 72. Helen will turn 72 in 2021. She must take a distribution by April 1, 2022, and another distribution by December 31, 2022.*

**Answer 9:** *A. Generally, Form W-4P, Withholding Certificate for Periodic Pension and Annuity Payments, is used to request a change in withholding on a pension.*