



Department of the Treasury
Internal Revenue Service

Publication 575

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Pension and Annuity Income

For use in preparing
2002 Returns



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Important Changes

Required distributions. The IRS announced new rules that simplify the calculation of required distributions. See *Required distributions* under *Tax on Excess Accumulation*.

Rollovers to and from qualified retirement plans. For distributions made after 2001, for rollover purposes, tax-sheltered annuity plans (403(b) plans) and eligible state or local government section 457 deferred compensation plans are qualified retirement plans. See *Rollovers*.

Hardship distribution rollovers. A hardship distribution made after 2001 from any retirement plan is not an eligible rollover distribution. See *Rollovers*.

Time for making rollover. The 60-day period for completing the rollover of an eligible rollover distribution may be extended for distributions made after 2001 in certain cases of casualty, disaster, or other events beyond your reasonable control. See *Rollovers*.

Rollover by surviving spouse. You may be able to roll over a distribution made after 2001 you receive as the surviving spouse of a deceased employee into a qualified retirement plan or a traditional IRA. See *Rollovers*.

Eligible rollover distribution. You may be able to roll over the nontaxable part of a retirement plan distribution made after 2001 to another qualified retirement plan or a traditional IRA. See *Rollovers*.

Section 457 plan early distributions. The tax on early distributions may apply to certain distributions made from an eligible state or local government section 457 deferred compensation plan after 2001. See *Tax on Early Distributions*.

Important Reminder

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST (1-800-843-5678)** if you recognize a child.

Introduction

This publication gives you the information you need to determine the tax treatment of distributions you receive from pension and annuity plans and also shows you how to report the income on your federal income tax return. How these distributions are taxed depends on whether they are **periodic payments** (amounts received as an annuity) that are paid at regular intervals over several years or **nonperiodic payments** (amounts not received as an annuity).

What is covered in this publication? Publication 575 contains information that you need to understand the following topics.

- How to figure the tax-free part of periodic payments under a pension or annuity plan, including using a simple worksheet for payments under a qualified plan.
- How to figure the tax-free part of nonperiodic payments from qualified and nonqualified plans, and how to use the optional methods to figure the tax on lump-sum distributions from pension, stock bonus, and profit-sharing plans.
- How to roll over certain distributions from a retirement plan into another retirement plan or IRA.
- How to report disability payments, and how beneficiaries and survivors of employees and retirees must report benefits paid to them.
- When additional taxes on certain distributions may apply (including the tax on early distributions and the tax on excess accumulation).



For additional information on how to report pension or annuity payments on your federal income tax return, be sure to review the instructions on the back of Copies B and C of the Form 1099-R that you received and the instructions for lines 16a and 16b of Form 1040 (lines 12a and 12b of Form 1040A).

What is not covered in this publication? The following topics are not discussed in this publication.

- **The General Rule.** This is the method generally used to determine the tax treatment of pension and annuity income from nonqualified plans (including commercial annuities). For a qualified plan, you generally cannot use the General Rule unless your annuity starting date is before November 19, 1996. Although this publication will help you determine whether you can use the General Rule, it will not help you use it to determine the tax treatment of your pension or annuity income. For more information on the General Rule, see Publication 939, *General Rule for Pensions and Annuities*.
- **Individual retirement arrangements (IRAs).** Information on the tax treatment of amounts you receive from an IRA is in Publication 590, *Individual Retirement Arrangements (IRAs)*.
- **Civil service retirement benefits.** If you are retired from the federal government (either regular or disability retirement) or are the survivor or beneficiary of a federal employee or retiree who died, get Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits*. Publication 721 covers the tax treatment of federal retirement benefits, primarily those paid under the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS).
- **Social security and equivalent tier 1 railroad retirement benefits.** For information about the tax treatment of these benefits, see Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*. However, this publication (575) covers the tax treatment of nonequivalent tier 1 railroad retirement benefits, tier 2 benefits, vested dual benefits, and supplemental annuity benefits paid by the U.S. Railroad Retirement Board.
- **Tax-sheltered annuity plans (403(b) plans).** If you work for a public school or certain tax-exempt organizations, you may be eligible to participate in a 403(b) retirement plan offered by your employer. Although this publication covers the treatment of benefits under 403(b) plans, it does not cover other tax provisions that apply to these plans. For more information on 403(b) plans, see Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans)*.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can e-mail us while visiting our web site at www.irs.gov.

You can write to us at the following address:

Internal Revenue Service
Technical Publications Branch
W:CAR:MP:FP:P
1111 Constitution Ave. NW
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Useful Items

You may want to see:

Publication

- 524** Credit for the Elderly or the Disabled
- 525** Taxable and Nontaxable Income
- 560** Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)
- 571** Tax-Sheltered Annuity Plans (403(b) Plans)
- 590** Individual Retirement Arrangements (IRAs)
- 721** Tax Guide to U.S. Civil Service Retirement Benefits
- 915** Social Security and Equivalent Railroad Retirement Benefits
- 939** General Rule for Pensions and Annuities

Form (and Instructions)

- W-4P** Withholding Certificate for Pension or Annuity Payments
- 1099-R** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- 4972** Tax on Lump-Sum Distributions
- 5329** Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

See *How To Get Tax Help* near the end of this publication for information about getting publications and forms.

General Information

Some of the terms used in this publication are defined in the following paragraphs.

- A **pension** is generally a series of definitely determinable payments made to you after you retire from work. Pension payments are made regularly and are based on certain factors, such as years of service with your employer or your prior compensation.

- An **annuity** is a series of payments under a contract made at regular intervals over a period of more than one full year. They can be either fixed (under which you receive a definite amount) or variable (not fixed). You can buy the contract alone or with the help of your employer.
- A **qualified employee plan** is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees or their beneficiaries and that meets Internal Revenue Code requirements. It qualifies for special tax benefits, such as tax deferral for employer contributions and capital gain treatment or the 10-year tax option for lump-sum distributions (if participants qualify). To determine whether your plan is a qualified plan, check with your employer or the plan administrator.
- A **qualified employee annuity** is a retirement annuity purchased by an employer for an employee under a plan that meets Internal Revenue Code requirements.
- A **tax-sheltered annuity plan** (often referred to as a **403(b) plan** or a **tax-deferred annuity plan**) is a retirement plan for employees of public schools and certain tax-exempt organizations. Generally, a tax-sheltered annuity plan provides retirement benefits by purchasing annuity contracts for its participants.

Types of pensions and annuities. Pensions and annuities include the following types.

- 1) **Fixed-period annuities.** You receive definite amounts at regular intervals for a specified length of time.
- 2) **Annuities for a single life.** You receive definite amounts at regular intervals for life. The payments end at death.
- 3) **Joint and survivor annuities.** The first annuitant receives a definite amount at regular intervals for life. After he or she dies, a second annuitant receives a definite amount at regular intervals for life. The amount paid to the second annuitant may or may not differ from the amount paid to the first annuitant.
- 4) **Variable annuities.** You receive payments that may vary in amount for a specified length of time or for life. The amounts you receive may depend upon such variables as profits earned by the pension or annuity funds, cost-of-living indexes, or earnings from a mutual fund.
- 5) **Disability pensions.** You receive disability payments because you retired on disability and have not reached minimum retirement age.

More than one program. You may receive employee plan benefits from more than one program under a single trust or plan of your employer. If you participate in more

than one program, you may have to treat each as a separate contract, depending upon the facts in each case. Also, you may be considered to have received more than one pension or annuity. Your former employer or the plan administrator should be able to tell you if you have more than one pension or annuity contract.

Example. Your employer set up a noncontributory **profit-sharing plan** for its employees. The plan provides that the amount held in the account of each participant will be paid when that participant retires. Your employer also set up a contributory defined benefit **pension plan** for its employees providing for the payment of a lifetime pension to each participant after retirement.

The amount of any distribution from the profit-sharing plan depends on the contributions (including allocated forfeitures) made for the participant and the earnings from those contributions. Under the pension plan, however, a formula determines the amount of the pension benefits. The amount of contributions is the amount necessary to provide that pension.

Each plan is a separate program and a separate contract. If you get benefits from these plans, you must account for each separately, even though the benefits from both may be included in the same check.

Qualified domestic relations order (QDRO). A spouse or former spouse who receives part of the benefits from a retirement plan under a QDRO reports the payments received as if he or she were a plan participant. The spouse or former spouse is allocated a share of the participant's cost (investment in the contract) equal to the cost times a fraction. The numerator (top part) of the fraction is the present value of the benefits payable to the spouse or former spouse. The denominator (bottom part) is the present value of all benefits payable to the participant.

A distribution that is paid to a child or other dependent under a QDRO is taxed to the plan participant.

What is a QDRO? A QDRO is a judgment, decree, or order relating to payment of child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent. The QDRO must contain certain specific information, such as the name and last known mailing address of the participant and each alternate payee, and the amount or percentage of the participant's benefits to be paid to each alternate payee. A QDRO may not award an amount or form of benefit that is not available under the plan.

Variable Annuities

The tax rules in this publication apply both to annuities that provide fixed payments and to annuities that provide payments that vary in amount based on investment results or other factors. For example, they apply to commercial variable annuity contracts, whether bought by an employee retirement plan for its participants or bought directly from the issuer by an individual investor. Under these contracts, the owner can generally allocate the purchase payments among several types of investment portfolios or mutual funds and the contract value is determined by the perform-

ance of those investments. The earnings are not taxed until distributed either in a withdrawal or in annuity payments. The taxable part of a distribution is treated as ordinary income.

For information on the tax treatment of a transfer or exchange of a variable annuity contract, see *Transfers of Annuity Contracts* under *Taxation of Nonperiodic Payments*, later.

Withdrawals. If you withdraw funds **before your annuity starting date** and your annuity is under a qualified retirement plan, a ratable part of the amount withdrawn is tax free. The tax-free part is based on the ratio of your cost (investment in the contract) to your account balance under the plan.

If your annuity is under a nonqualified plan (including a contract you bought directly from the issuer), the amount withdrawn is allocated first to earnings (the taxable part) and then to your cost (the tax-free part). However, if you bought your annuity contract before August 14, 1982, a different allocation applies to the investment before that date and the earnings on that investment. To the extent the amount withdrawn does not exceed that investment and earnings, it is allocated first to your cost (the tax-free part) and then to earnings (the taxable part).

If you withdraw funds (other than as an annuity) **on or after your annuity starting date**, the entire amount withdrawn is generally taxable.

The amount you receive in a **full surrender** of your annuity contract at any time is tax free to the extent of any cost that you have not previously recovered tax free. The rest is taxable.

For more information on the tax treatment of withdrawals, see *Taxation of Nonperiodic Payments*, later. If you withdraw funds from your annuity before you reach age 59½, also see *Tax on Early Distributions* under *Special Additional Taxes*, later.

Annuity payments. If you receive annuity payments under a variable annuity plan or contract, you recover your cost tax free under either the Simplified Method or the General Rule, as explained under *Taxation of Periodic Payments*, later. For a variable annuity paid under a qualified plan, you generally must use the Simplified Method. For a variable annuity paid under a nonqualified plan (including a contract you bought directly from the issuer), you must use a special computation under the General Rule. For more information, see *Variable annuities* in Publication 939 under *Computation Under the General Rule*.

Death benefits. If you receive a single-sum distribution from a variable annuity contract because of the death of the owner or annuitant, the distribution is generally taxable only to the extent it is more than the unrecovered cost of the contract. If you choose to receive an annuity, the payments are subject to tax as described above. If the contract provides a joint and survivor annuity and the primary annuitant had received annuity payments before death, you figure the tax-free part of annuity payments you receive as the survivor in the same way the primary annuitant did. See *Survivors and Beneficiaries*, later.

Section 457 Deferred Compensation Plans

If you work for a state or local government or for a tax-exempt organization, you may be able to participate in a section 457 deferred compensation plan. If your plan is an eligible plan, you are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. You are taxed on amounts deferred in an eligible state or local government plan only when they are distributed from the plan. You are taxed on amounts deferred in an eligible tax-exempt organization plan when they are distributed or otherwise made available to you.

This publication covers the tax treatment of benefits under eligible section 457 plans, but it does not cover the treatment of deferrals. For information on deferrals under section 457 plans, see *Retirement Plan Contributions* under *Employee Compensation* in Publication 525.

Is your plan eligible? To find out if your plan is an eligible plan, check with your employer. The following plans are **not** eligible section 457 plans.

- 1) Bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plans.
- 2) Nonelective deferred compensation plans for nonemployees (independent contractors).
- 3) Deferred compensation plans maintained by churches.
- 4) Length of service award plans for bona fide volunteer firefighters and emergency medical personnel. An exception applies if the total amount paid to a volunteer exceeds \$3,000 for any year of service.

Disability Pensions

If you retired on disability, you generally must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A until you reach **minimum retirement age**. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled.



You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see Publication 524.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on lines 16a and 16b of Form 1040, or on lines 12a and 12b of Form 1040A.



For tax years ending after September 10, 2001, disability payments for injuries incurred as a direct result of a terrorist attack directed against the United States (or its allies), whether outside or within the

United States, are not included in income. For more information about payments to survivors of terrorists attacks, see Publication 3920, Tax Relief for Victims of Terrorist Attacks..

Railroad Retirement

Benefits paid under the Railroad Retirement Act fall into two categories. These categories are treated differently for income tax purposes.

The **first category** is the amount of tier 1 railroad retirement benefits that equals the social security benefit that a railroad employee or beneficiary would have been entitled to receive under the social security system. This part of the tier 1 benefit is the social security equivalent benefit (SSEB) and you treat it for tax purposes like social security benefits. If you received or repaid the SSEB portion of tier 1 benefits during 2002, you will receive Form RRB-1099, *Payments by the Railroad Retirement Board* (or Form RRB-1042S, *Statement for Nonresident Aliens of Payments by the Railroad Retirement Board*, if you are a nonresident alien) from the U.S. Railroad Retirement Board (RRB).

For more information about the tax treatment of the SSEB portion of tier 1 benefits and Forms RRB-1099 and RRB-1042S, see Publication 915.

The **second category** contains the rest of the tier 1 railroad retirement benefits, called the non-social security equivalent benefit (NSSEB). It also contains any tier 2 benefit, vested dual benefit (VDB), and supplemental annuity benefit. Treat this category of benefits, shown on Form RRB-1099-R, as an amount received from a qualified employee plan. This allows for the tax-free (nontaxable) recovery of employee contributions from the tier 2 benefits and the NSSEB part of the tier 1 benefits. (NSSEB and tier 2 benefits, less certain repayments, are combined into one amount called the Contributory Amount Paid on Form RRB-1099-R.) Vested dual benefits and supplemental annuity benefits are fully taxable. See *Taxation of Periodic Payments*, later, for information on how to report your benefits and how to recover the employee contributions tax free.

Nonresident aliens. Form RRB-1099-R is used for U.S. citizens, resident aliens, and nonresident aliens. If you are a nonresident alien and your tax withholding rate changed or your country of legal residence changed during the year, you may receive more than one Form RRB-1099-R. To determine your total benefits paid or repaid and total tax withheld for the year, you should add the amounts shown on all Forms RRB-1099-R you received for that year. For information on filing requirements for aliens, see Publication 519, *U.S. Tax Guide for Aliens*. For information on tax treaties between the United States and other countries that may reduce or eliminate U.S. tax on your benefits, see Publication 901, *U.S. Tax Treaties*.

Form RRB-1099-R. The following discussion explains the items shown on Form RRB-1099-R. The amounts shown on this form are **before** any deduction for:

- Federal income tax withholding,

PAYERS' NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE UNITED STATES RAILROAD RETIREMENT BOARD 844 N RUSH ST CHICAGO IL 60611-2092		2002		ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD		
PAYER'S FEDERAL IDENTIFYING NO. 36-3314600		3. Employee Contributions		COPY B - REPORT THIS INCOME ON YOUR FEDERAL TAX RETURN. IF THIS FORM SHOWS FEDERAL INCOME TAX WITHHELD IN BOX 9 ATTACH THIS COPY TO YOUR RETURN. THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.		
1. Claim Number and Payee Code	4. Contributory Amount Paid					
2. Recipient's Identification Number	5. Vested Dual Benefit					
Recipient's Name, Street Address, City, State, and ZIP Code	6. Supplemental Annuity					
	7. Total Gross Paid					
	8. Repayments					
	9. Federal Income Tax Withheld					
10. Rate of Tax			11. Country			12. Medicare Premium Total

FORM RRB-1099-R

- Medicare premiums,
- Legal process garnishment payments,
- Legal process assignment payments,
- Recovery of a prior year overpayment of an NSSEB, tier 2 benefit, VDB, or supplemental annuity benefit, and
- Recovery of Railroad Unemployment Insurance Act benefits received while awaiting payment of your railroad retirement annuity.

The amounts shown on this form are **after** any offset for:

- Work deductions,
- Legal process partition payments,
- Actuarial adjustment,
- Annuity waiver, or
- Recovery of a current-year overpayment of NSSEB, tier 2, VDB, or supplemental annuity benefits.

The amounts shown on Form RRB-1099-R do not reflect any special rules, such as capital gain treatment or the special 10-year tax option for lump-sum payments, or tax-free rollovers. To determine if any of these rules apply to your benefits, see the discussions about them later.

There are three copies of this form. Copy B is to be included with your income tax return. Copy C is for your own records. Copy 2 is filed with your state, city, or local income tax return, when required. See the illustrated Copy B (Form RRB-1099-R) above.



Each beneficiary will receive his or her own Form RRB-1099-R. If you receive benefits on more than one railroad retirement record, you may get more than one Form RRB-1099-R. So that you get your form timely, make sure the RRB always has your current mailing address.

Box 1—Claim Number and Payee Code. Your claim number is a six- or nine-digit number preceded by an alphabetical prefix. This is the number under which the U.S. Railroad Retirement Board (RRB) paid your benefits. Your payee code follows your claim number and is the last number in this box. It is used by the RRB to identify you under your claim number. In all your correspondence with the RRB, be sure to use the claim number and payee code shown in this box.

Box 2—Recipient's Identification Number. This is the social security number (SSN), individual taxpayer identification number (ITIN), or employer identification number (EIN), if known, for the person or estate listed as the recipient.



If you are a resident or nonresident alien who must furnish a taxpayer identification number to the IRS and are not eligible to obtain an SSN, use Form W-7, Application for IRS Individual Taxpayer Identification Number, to apply for an ITIN. The instructions for Form W-7 explain how and when to apply.

Box 3—Employee Contributions. This is the amount of taxes withheld from the railroad employee's earnings that exceeds the amount of taxes that would have been withheld had the earnings been covered under the social security system. This amount is the employee's cost (investment in the contract) that you use to figure the tax-free part of the NSSEB and tier 2 benefit you received (the amount shown in box 4). (For information on how to figure the tax-free part, see *Partly Taxable Payments* under *Taxation of Periodic Payments*, later.) The amount shown is the total employee contributions, not reduced by any amounts that the RRB calculated as previously recovered. It is the latest amount reported for 2002 and may have increased or decreased from a previous Form RRB-1099-R. If this amount has changed, you may need to refigure the tax-free part of your NSSEB/tier 2 benefit. If

this box is blank, it means that the amount of your NSSEB and tier 2 payments shown in box 4 is fully taxable.



If you had a previous annuity entitlement that ended and you are figuring the tax-free part of your NSSEB/tier 2 benefit for your current annuity entitlement, you should contact the RRB for confirmation of your correct employee contributions amount.

Box 4—Contributory Amount Paid. This is the gross amount of NSSEB and tier 2 benefit you received in 2002, **less** any 2002 benefits you repaid in 2002. (Any benefits you repaid in 2002 for an earlier year or for an unknown year are shown in box 8.) This amount is the total contributory pension paid in 2002 and is usually partly taxable and partly tax free. You figure the tax-free part as explained in *Partly Taxable Payments* under *Taxation of Periodic Payments*, later, using the latest reported amount of employee contributions shown in box 3 as the cost (investment in the contract).

Box 5—Vested Dual Benefit. This is the gross amount of vested dual benefit (VDB) payments paid in 2002, **less** any 2002 VDB payments you repaid in 2002. It is fully taxable. VDB payments you repaid in 2002 for an earlier year or for an unknown year are shown in box 8.

Note. The amounts shown in boxes 4 and 5 may represent payments for 2002 and/or other years after 1983.

Box 6—Supplemental Annuity. This is the gross amount of supplemental annuity benefits paid in 2002, **less** any 2002 supplemental annuity benefits you repaid in 2002. It is fully taxable. Supplemental annuity benefits you repaid in 2002 for an earlier year or for an unknown year are shown in box 8.

Box 7—Total Gross Paid. This is the sum of boxes 4, 5, and 6. The amount represents the total pension paid in 2002. Include this amount on line 16a of your Form 1040, line 12a of your Form 1040A, or line 17a of your Form 1040NR.

Box 8—Repayments. This amount represents any NSSEB, tier 2 benefit, VDB, and supplemental annuity benefit you repaid to the RRB in 2002 for years **before** 2002 or for unknown years. The amount shown in this box has not been deducted from the amounts shown in boxes 4, 5, and 6. It only includes repayments of benefits that were taxable to you. This means it only includes repayments in 2002 of NSSEB benefits paid after 1985, tier 2 and VDB benefits paid after 1983, and supplemental annuity benefits paid in any year. If you included the benefits in your income in the year you received them, you may be able to deduct the repaid amount. For more information about repayments, see *Repayment of benefits received in an earlier year*, later.



You may have repaid an overpayment of benefits by returning a payment, by making a cash refund, or by having an amount withheld.

Box 9—Federal Income Tax Withheld. This is the total federal income tax withheld from your NSSEB, tier 2

benefit, VDB, and supplemental annuity benefit. Include this on your income tax return as tax withheld. If you are a nonresident alien and your tax withholding rate and/or country of legal residence changed during 2002, you will receive more than one Form RRB-1099-R for 2002. Therefore, add the amounts in box 9 of all Forms RRB-1099-R you receive for 2002 to determine your **total amount** of U.S. federal income tax withheld for 2002.

Box 10—Rate of Tax. If you are taxed as a U.S. citizen or resident alien, this box does **not** apply to you. If you are a nonresident alien, an entry in this box indicates the rate at which tax was withheld on the NSSEB, tier 2, VDB, and supplemental annuity payments that were paid to you in 2002. If you are a nonresident alien whose tax was withheld at more than one rate during 2002, you will receive a separate Form RRB-1099-R for each rate change during 2002.

Box 11—Country. If you are taxed as a U.S. citizen or resident alien, this box does **not** apply to you. If you are a nonresident alien, an entry in this box indicates the country of which you were a resident for tax purposes at the time you received railroad retirement payments in 2002. If you are a nonresident alien who was a resident of more than one country during 2002, you will receive a separate Form RRB-1099-R for each country of residence during 2002.

Box 12—Medicare Premium Total. This is for information purposes only. The amount shown in this box represents the total amount of Part B Medicare premiums deducted from your railroad retirement annuity payments in 2002. Medicare premium refunds are **not** included in the Medicare total. The Medicare total is normally shown on Form RRB-1099 (if you are a citizen or resident of the United States) or Form RRB-1042S (if you are a nonresident alien). However, if Form RRB-1099 or Form RRB-1042S is not required for 2002, then this total will be shown on Form RRB-1099-R. If your Medicare premiums were deducted from your social security benefits, paid by a third party, and/or you paid the premiums by direct billing, your Medicare total will not be shown in this box.

Help from the RRB. For assistance with questions about your Form RRB-1099-R, you should contact your nearest RRB field office (if you reside in the United States) or U.S. consulate/embassy (if you reside outside the United States). You can visit the RRB on the Internet at www.rrb.gov.

Repayment of benefits received in an earlier year. If you had to repay any railroad retirement benefits that you had included in your income in an earlier year because at that time you thought you had an unrestricted right to it, you can deduct the amount you repaid in the year in which you repaid it.

If you repaid **\$3,000 or less** in 2002, deduct it on line 22 of Schedule A (Form 1040). The 2%-of-adjusted-gross-income limit applies to this deduction. You cannot take this deduction if you file Form 1040A.

If you repaid **more than \$3,000** in 2002, you can either take a deduction for the amount repaid on line 27 of Schedule A (Form 1040) or you can take a credit against

your tax. For more information, see *Repayments* in Publication 525.

Withholding Tax and Estimated Tax

Your retirement plan distributions are subject to federal income tax withholding. However, you can choose not to have tax withheld on payments you receive unless they are eligible rollover distributions. If you choose not to have tax withheld or if you do not have enough tax withheld, you may have to make estimated tax payments. See *Estimated tax*, later.

The withholding rules apply to the **taxable part** of payments you receive from:

- An employer pension, annuity, profit-sharing, or stock bonus plan,
- Any other deferred compensation plan,
- A traditional individual retirement arrangement (IRA), or
- A commercial annuity.

For this purpose, a commercial annuity means an annuity, endowment, or life insurance contract issued by an insurance company.



There will be no withholding on any part of a distribution that (it is reasonable to believe) will not be includible in gross income.

These withholding rules also apply to disability pension distributions received before your minimum retirement age. See *Disability Pensions*, earlier.

Choosing no withholding. You can choose not to have income tax withheld from retirement plan payments unless they are eligible rollover distributions. This applies to periodic and nonperiodic payments. The payer will tell you how to make the choice. This choice generally remains in effect until you revoke it.

The payer will ignore your choice not to have tax withheld if:

- You do not give the payer your social security number (in the required manner), or
- The IRS notifies the payer, before the payment is made, that you gave an incorrect social security number.

To choose not to have tax withheld, a U.S. citizen or resident must give the payer a home address in, and have the check delivered to an address in, the United States or its possessions. Without that address, the payer must withhold tax. For example, the payer has to withhold tax if the recipient has provided a U.S. address for a nominee, trustee, or agent to whom the benefits are delivered, but has not provided his or her own U.S. home address.

If you do not give the payer a home address in the United States or its possessions, you can choose not to have tax withheld only if you certify to the payer that you

are not a U.S. citizen, a U.S. resident alien, or someone who left the country to avoid tax. But if you so certify, you may be subject to the 30% flat rate withholding that applies to nonresident aliens. This 30% rate will not apply if you are exempt or subject to a reduced rate by treaty. For details, get Publication 519, *U.S. Tax Guide for Aliens*.

Periodic payments. Unless you choose no withholding, your annuity or similar periodic payments (other than eligible rollover distributions) will be treated like wages for withholding purposes. Periodic payments are amounts paid at regular intervals (such as weekly, monthly, or yearly) for a period of time greater than one year (such as for 15 years or for life). You should give the payer a completed withholding certificate (Form W-4P or a similar form provided by the payer). If you do not, tax will be withheld as if you were married and claiming three withholding allowances.

Tax will be withheld as if you were single and were claiming no withholding allowances if:

- You do not give the payer your social security number (in the required manner), or
- The IRS notifies the payer (before any payment is made) that you gave an incorrect social security number.

You must file a new withholding certificate to change the amount of withholding.

Nonperiodic distributions. For a nonperiodic distribution (a payment other than a periodic payment) that is not an eligible rollover distribution, the withholding is 10% of the distribution, unless you choose not to have tax withheld. You can use Form W-4P to elect to have no income tax withheld. You can also ask the payer to withhold an additional amount using Form W-4P. The part of any loan treated as a distribution (except an offset amount to repay the loan), explained later, is subject to withholding under this rule.

Eligible rollover distribution. If you receive an eligible rollover distribution, 20% of it generally will be withheld for income tax. You cannot choose not to have tax withheld from an eligible rollover distribution. However, tax will not be withheld if you have the plan administrator pay the eligible rollover distribution directly to another qualified plan or an IRA in a direct rollover. For more information about eligible rollover distributions, see *Rollovers*, later.

Estimated tax. Your estimated tax is the total of your expected income tax, self-employment tax, and certain other taxes for the year, minus your expected credits and withheld tax. Generally, you must make estimated tax payments for 2003 if your estimated tax, as defined above, is \$1,000 or more and you estimate that the total amount of income tax to be withheld will be less than the smaller of:

- 1) 90% of the tax to be shown on your 2003 return, or
- 2) 100% of the tax shown on your 2002 return.

If your adjusted gross income for 2002 was more than \$150,000 (\$75,000 if your filing status is married filing

separately), substitute 110% for 100% in (2) above. For more information, get Publication 505, *Tax Withholding and Estimated Tax*.



In figuring your withholding or estimated tax, remember that a part of your monthly social security or equivalent tier 1 railroad retirement benefits may be taxable. See Publication 915. You can choose to have income tax withheld from those benefits. Use Form W-4V, Voluntary Withholding Request, to make this choice.

Cost (Investment in the Contract)

Distributions from your pension or annuity plan may include amounts treated as a recovery of your cost (investment in the contract). If any part of a distribution is treated as a recovery of your cost under the rules explained in this publication, that part is tax free. Therefore, the first step in figuring how much of a distribution is taxable is to determine the cost of your pension or annuity.

In general, your cost is your net investment in the contract as of the annuity starting date (or the date of the distribution, if earlier). To find this amount, you must first figure the total premiums, contributions, or other amounts you paid. This includes the amounts your employer contributed that were taxable when paid. (Also see *Foreign employment contributions*, later.) It does not include amounts withheld from your pay on a tax-deferred basis (money that was taken out of your gross pay before taxes were deducted). It also does not include amounts you contributed for health and accident benefits (including any additional premiums paid for double indemnity or disability benefits).

From this total cost you must subtract the following amounts.

- 1) Any refunded premiums, rebates, dividends, or unrepaid loans that were not included in your income and that you received by the later of the annuity starting date or the date on which you received your first payment.
- 2) Any other tax-free amounts you received under the contract or plan by the later of the dates in (1).
- 3) If you must use the Simplified Method for your annuity payments, the tax-free part of any single-sum payment received in connection with the start of the annuity payments, regardless of when you received it. (See *Simplified Method*, later, for information on its required use.)
- 4) If you use the General Rule for your annuity payments, the value of the refund feature in your annuity contract. (See *General Rule*, later, for information on its use.) Your annuity contract has a refund feature if the annuity payments are for your life (or the lives of you and your survivor) and payments in the nature of

a refund of the annuity's cost will be made to your beneficiary or estate if all annuitants die before a stated amount or a stated number of payments are made. For more information, see Publication 939.

The tax treatment of the items described in (1) through (3) above is discussed later under *Taxation of Nonperiodic Payments*.



Form 1099-R. If you began receiving periodic payments of a life annuity in 2002, the payer should show your total contributions to the plan in box 9b of your 2002 Form 1099-R.

Annuity starting date defined. Your annuity starting date is the later of the first day of the first period for which you received a payment or the date the plan's obligations became fixed.

Example. On January 1, you completed all your payments required under an annuity contract providing for monthly payments starting on August 1 for the period beginning July 1. The annuity starting date is July 1. This is the date you use in figuring the cost of the contract and selecting the appropriate number from the table for line 3 of the Simplified Method Worksheet.

Foreign employment contributions. If you worked abroad, your cost includes amounts contributed by your employer that were not includible in your gross income. This applies to contributions that were made either:

- 1) Before 1963 by your employer for that work,
- 2) After 1962 by your employer for that work if you performed the services under a plan that existed on March 12, 1962, or
- 3) After 1996 by your employer on your behalf if you performed the services of a foreign missionary (a duly ordained, commissioned, or licensed minister of a church or a lay person).

Taxation of Periodic Payments

This section explains how the periodic payments you receive from a pension or annuity plan are taxed. Periodic payments are amounts paid at regular intervals (such as weekly, monthly, or yearly) for a period of time greater than one year (such as for 15 years or for life). These payments are also known as **amounts received as an annuity**. If you receive an amount from your plan that is **not** a periodic payment, see *Taxation of Nonperiodic Payments*, later.

In general, you can recover the cost of your pension or annuity tax free over the period you are to receive the payments. The amount of each payment that is more than the part that represents your cost is taxable.

Fully Taxable Payments

The pension or annuity payments that you receive are fully taxable if you have **no cost** in the contract because:

- 1) You did not pay anything or are not considered to have paid anything for your pension or annuity,
- 2) Your employer did not withhold contributions from your salary, or
- 3) You got back all of your contributions tax free in prior years (however, see *Exclusion not limited to cost* under *Partly Taxable Payments*, later).

Report the total amount you got on line 16b, Form 1040, or line 12b, Form 1040A. You should make no entry on line 16a, Form 1040, or line 12a, Form 1040A.

Deductible voluntary employee contributions. Distributions you receive that are based on your accumulated deductible voluntary employee contributions are generally fully taxable in the year distributed to you. Accumulated deductible voluntary employee contributions include net earnings on the contributions. If distributed as part of a lump sum, they do not qualify for the 10-year tax option or capital gain treatment.

Partly Taxable Payments

If you have a cost to recover from your pension or annuity plan (see *Cost (Investment in the Contract)*, earlier), you can exclude part of each annuity payment from income as a recovery of your cost. This tax-free part of the payment is figured when your annuity starts and remains the same each year, even if the amount of the payment changes. The rest of each payment is taxable.

You figure the tax-free part of the payment using one of the following methods.

- **Simplified Method.** You generally must use this method if your annuity is paid under a qualified plan (a qualified employee plan, a qualified employee annuity, or a tax-sheltered annuity plan or contract). You cannot use this method if your annuity is paid under a nonqualified plan.
- **General Rule.** You must use this method if your annuity is paid under a nonqualified plan. You generally cannot use this method if your annuity is paid under a qualified plan.

You determine which method to use when you first begin receiving your annuity, and you continue using it each year that you recover part of your cost.

Qualified plan annuity starting before November 19, 1996. If your annuity is paid under a qualified plan and your annuity starting date (defined earlier under *Cost (Investment in the Contract)*) is after July 1, 1986, and before November 19, 1996, you could have chosen to use either the Simplified Method or the General Rule. If your annuity starting date is before July 2, 1986, you use the General Rule unless your annuity qualified for the Three-Year Rule.

If you used the Three-Year Rule (which was repealed for annuities starting after July 1, 1986), your annuity payments are now fully taxable.

Exclusion limit. Your annuity starting date determines the total amount of annuity payments that you can exclude from income over the years.

Exclusion limited to cost. If your annuity starting date is after 1986, the total amount of annuity income that you can exclude over the years as a recovery of the cost cannot exceed your total cost. Any unrecovered cost at your (or the last annuitant's) death is allowed as a miscellaneous itemized deduction on the final return of the decedent. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

Example 1. Your annuity starting date is after 1986, and you exclude \$100 a month under the Simplified Method. The total cost of your annuity is \$12,000. Your exclusion ends when you have recovered your cost tax free, that is, after 10 years (120 months). After that, your annuity payments are fully taxable.

Example 2. The facts are the same as in *Example 1*, except you die (with no surviving annuitant) after the eighth year of retirement. You have recovered tax free only \$9,600 ($8 \times \$1,200$) of your cost. An itemized deduction for your unrecovered cost of \$2,400 (\$12,000 minus \$9,600) can be taken on your final return.

Exclusion not limited to cost. If your annuity starting date is before 1987, you can continue to take your monthly exclusion for as long as you receive your annuity. If you chose a joint and survivor annuity, your survivor can continue to take the survivor's exclusion figured as of the annuity starting date. The total exclusion may be more than your cost.

Simplified Method

Under the Simplified Method, you figure the tax-free part of each annuity payment by dividing your cost by the total number of anticipated monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Who must use the Simplified Method. You must use the Simplified Method if your annuity starting date is after November 18, 1996, and you meet **both** of the following conditions.

- 1) You receive your pension or annuity payments from any of the following plans.
 - a) A qualified employee plan.
 - b) A qualified employee annuity.
 - c) A tax-sheltered annuity plan (403(b) plan).

2) On your annuity starting date, at least one of the following conditions applies to you.

- a) You are under age 75.
- b) You are entitled to less than 5 years of guaranteed payments.


Guaranteed payments. Your annuity contract provides guaranteed payments if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to less than 5 years of guaranteed payments.

Annuity starting before November 19, 1996. If your annuity starting date is after July 1, 1986, and before November 19, 1996, and you chose to use the Simplified Method, you must continue to use it each year that you recover part of your cost. You could have chosen to use the Simplified Method if your annuity is payable for your life (or the lives of you and your survivor annuitant) and you met both of the conditions listed earlier for annuities starting after November 18, 1996 (under *Who must use the Simplified Method*).

Who cannot use the Simplified Method. You cannot use the Simplified Method if you receive your pension or annuity from a nonqualified plan or otherwise do not meet the conditions described in the preceding discussion. See *General Rule*, later.

How to use it. Complete the worksheet in the back of this publication to figure your taxable annuity for 2002. Be sure to keep the completed worksheet; it will help you figure your taxable annuity next year.

To complete line 3 of the worksheet, you must determine the total number of expected monthly payments for your annuity. How you do this depends on whether the annuity is for a single life, multiple lives, or a fixed period. For this purpose, treat an annuity that is payable over the life of an annuitant as payable for that annuitant's life even if the annuity has a fixed-period feature or also provides a temporary annuity payable to the annuitant's child under age 25.

 **TIP** You do not need to complete line 3 of the worksheet or make the computation on line 4 if you received annuity payments last year and used last year's worksheet to figure your taxable annuity. Instead, enter the amount from line 4 of last year's worksheet on line 4 of this year's worksheet.

Single-life annuity. If your annuity is payable for your life alone, use Table 1 at the bottom of the worksheet to determine the total number of expected monthly payments. Enter on line 3 the number shown for your age on your annuity starting date. This number will differ depend-

ing on whether your annuity starting date is before November 19, 1996, or after November 18, 1996.

Multiple-lives annuity. If your annuity is payable for the lives of more than one annuitant, use Table 2 at the bottom of the worksheet to determine the total number of expected monthly payments. Enter on line 3 the number shown for the annuitants' combined ages on the annuity starting date. For an annuity payable to you as the primary annuitant and to more than one survivor annuitant, combine your age and the age of the youngest survivor annuitant. For an annuity that has no primary annuitant and is payable to you and others as survivor annuitants, combine the ages of the oldest and youngest annuitants. Do not treat as a survivor annuitant anyone whose entitlement to payments depends on an event other than the primary annuitant's death.

However, **if your annuity starting date is before 1998**, do not use Table 2 and do not combine the annuitants' ages. Instead, you must use Table 1 at the bottom of the worksheet and enter on line 3 the number shown for the primary annuitant's age on the annuity starting date. This number will differ depending on whether your annuity starting date is before November 19, 1996, or after November 18, 1996.

Fixed-period annuity. If your annuity does not depend on anyone's life expectancy, the total number of expected monthly payments to enter on line 3 of the worksheet is the number of monthly annuity payments under the contract.

Example. Bill Kirkland, age 65, began receiving retirement benefits in 2002 under a joint and survivor annuity. Bill's annuity starting date is January 1, 2002. The benefits are to be paid for the joint lives of Bill and his wife, Kathy, age 65. Bill had contributed \$31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of \$1,200 a month, and Kathy is to receive a monthly survivor benefit of \$600 upon Bill's death.

Bill must use the Simplified Method to figure his taxable annuity because his payments are from a qualified plan and he is under age 75. Because his annuity is payable over the lives of more than one annuitant, he uses his and Kathy's combined ages and Table 2 at the bottom of the worksheet in completing line 3 of the worksheet. His completed worksheet is shown on the next page.

Bill's tax-free monthly amount is \$100 ($\$31,000 \div 310$ as shown on line 4 of the worksheet). Upon Bill's death, if Bill has not recovered the full \$31,000 investment, Kathy will also exclude \$100 from her \$600 monthly payment. The full amount of any annuity payments received after 310 payments are paid must be included in gross income.

If Bill and Kathy die before 310 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on the final income tax return of the last to die. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

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



1. Enter the total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a, or Form 1040A, line 12a	1. _____	\$ 14,400
2. Enter your cost in the plan (contract) at the annuity starting date	2. _____	31,000
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. 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. _____	100
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. _____	1,200
6. Enter any amount previously recovered tax free in years after 1986	6. _____	-0-
7. Subtract line 6 from line 2	7. _____	31,000
8. Enter the smaller of line 5 or line 7	8. _____	1,200
9. Taxable amount for year. Subtract line 8 from line 1. Enter the result, but not less than zero. Also, add this amount to the total for Form 1040, line 16b, or Form 1040A, line 12b. Note: If your Form 1099-R shows a larger taxable amount, use the amount on this line instead	9. _____	\$ 13,200
10. Add lines 6 and 8	10. _____	1,200
11. Balance of cost to be recovered. Subtract line 10 from line 2	11. _____	\$ 29,800

TABLE 1 FOR LINE 3 ABOVE

AND your annuity starting date was—

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

TABLE 2 FOR LINE 3 ABOVE

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

Multiple annuitants. If you and one or more other annuitants receive payments at the same time, you exclude from each annuity payment a pro rata share of the monthly tax-free amount. Figure your share in the following steps.

- 1) Complete your worksheet through line 4 to figure the monthly tax-free amount.
- 2) Divide the amount of your monthly payment by the total amount of the monthly payments to all annuitants.
- 3) Multiply the amount on line 4 of your worksheet by the amount figured in (2) above. The result is your share of the monthly tax-free amount.

Replace the amount on line 4 of the worksheet with the result in (3) above. Enter that amount on line 4 of your worksheet each year.

General Rule

Under the General Rule, you determine the tax-free part of each annuity payment based on the ratio of the cost of the contract to the total expected return. Expected return is the total amount you and other eligible annuitants can expect to receive under the contract. To figure it, you must use life expectancy (actuarial) tables prescribed by the IRS.

Who must use the General Rule. You must use the General Rule if you receive pension or annuity payments from:

- 1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
- 2) A qualified plan if you are age 75 or older on your annuity starting date and your annuity payments are guaranteed for at least 5 years.

Annuity starting before November 19, 1996. If your annuity starting date is after July 1, 1986, and before November 19, 1996, you had to use the General Rule for either circumstance described above. You also had to use it for any fixed-period annuity. If you did not have to use the General Rule, you could have chosen to use it. If your annuity starting date is before July 2, 1986, you had to use the General Rule unless you could use the Three-Year Rule.

If you had to use the General Rule (or chose to use it), you must continue to use it each year that you recover your cost.

Who cannot use the General Rule. You cannot use the General Rule if you receive your pension or annuity from a qualified plan and none of the circumstances described in the preceding discussions apply to you. See *Simplified Method*, earlier.

More information. For complete information on using the General Rule, including the actuarial tables you need, see Publication 939.

Taxation of Nonperiodic Payments

This section of the publication explains how any nonperiodic distributions you receive under a pension or annuity plan are taxed. Nonperiodic distributions are also known as **amounts not received as an annuity**. They include all payments other than periodic payments and corrective distributions.

For example, the following items are treated as nonperiodic distributions.

- Cash withdrawals.
- Distributions of current earnings (dividends) on your investment. However, do not include these distributions in your income to the extent the insurer keeps them to pay premiums or other consideration for the contract.
- Certain loans. See *Loans Treated as Distributions*, later.
- The value of annuity contracts transferred without full and adequate consideration. See *Transfers of Annuity Contracts*, later.

Corrective distributions of excess plan contributions.

If the contributions made for you during the year to certain retirement plans exceed certain limits, the excess is taxable to you. To correct an excess, your plan may distribute it to you (along with any income earned on the excess). Although the plan reports the corrective distributions on Form 1099-R, the distribution is **not** treated as a nonperiodic distribution from the plan. It is not subject to the allocation rules explained in the following discussion, it cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.



If your retirement plan made a corrective distribution of excess contributions (excess deferrals, excess contributions, or excess annual additions), your Form 1099-R should have the code "8," "D," "P," or "E" in box 7.

For information on plan contribution limits and how to report corrective distributions of excess contributions, see *Retirement Plan Contributions* under *Employee Compensation* in Publication 525.

Figuring the Taxable Amount

How you figure the taxable amount of a nonperiodic distribution depends on whether it is made before the annuity starting date or on or after the annuity starting date. If it is made before the annuity starting date, its tax treatment also depends on whether it is made under a qualified or nonqualified plan and, if it is made under a nonqualified plan, whether it fully discharges the contract or is allocable to an investment you made before August 14, 1982.



You may be able to roll over the taxable amount of a nonperiodic distribution from a qualified retirement plan into another qualified retirement plan or an IRA tax free. See Rollovers, later. If you do not make a tax-free rollover and the distribution qualifies as a lump-sum distribution, you may be able to elect an optional method of figuring the tax on the taxable amount. See Lump-Sum Distributions, later.

Annuity starting date. The annuity starting date is either the first day of the first period for which you receive an annuity payment under the contract or the date on which the obligation under the contract becomes fixed, whichever is later.

Distributions of employer securities. If you receive a distribution of employer securities from a qualified retirement plan, you may be able to defer the tax on the **net unrealized appreciation (NUA)** in the securities. The NUA is the increase in the securities' value while they were in the trust. This tax deferral applies to distributions of the employer corporation's stocks, bonds, registered debentures, and debentures with interest coupons attached.

If the distribution is a lump-sum distribution, tax is deferred on all of the NUA unless you choose to include it in your income for the year of the distribution.

A lump-sum distribution for this purpose is the distribution or payment of a plan participant's entire balance (within a single tax year) from all of the employer's qualified plans of one kind (pension, profit-sharing, or stock bonus plans), but only if paid:

- Because of the plan participant's death,
- After the participant reaches age 59½,
- Because the participant, if an employee, separates from service, or
- After the participant, if a self-employed individual, becomes totally and permanently disabled.



If you choose to include NUA in your income for the year of the distribution and the participant was born before 1936, you may be able to figure the tax on the NUA using the optional methods described under Lump-Sum Distributions, later.

If the distribution is not a lump-sum distribution, tax is deferred only on the NUA resulting from employee contributions other than deductible voluntary employee contributions.

The NUA on which tax is deferred should be shown in box 6 of the Form 1099-R you receive from the payer of the distribution.

When you sell or exchange employer securities with tax-deferred NUA, any gain is **long-term capital gain** up to the amount of the NUA. Any gain that is more than the NUA is long-term or short-term gain, depending on how long you held the securities after the distribution.

How to report. Enter the total amount of a nonperiodic distribution on line 16a of Form 1040 or line 12a of Form 1040A. Enter the taxable amount of the distribution on line

16b of Form 1040 or line 12b of Form 1040A. However, if you make a tax-free rollover or elect an optional method of figuring the tax on a lump-sum distribution, see *How to report* in the discussions of those tax treatments, later.

Distribution On or After Annuity Starting Date

If you receive a nonperiodic payment from your annuity contract **on or after the annuity starting date**, you generally must include all of the payment in gross income. For example, a cost-of-living increase in your pension after the annuity starting date is an amount not received as an annuity and, as such, is fully taxable.

Reduction in subsequent payments. If the annuity payments you receive are reduced because you received the nonperiodic distribution, you can exclude part of the nonperiodic distribution from gross income. The part you can exclude is equal to your cost in the contract reduced by any tax-free amounts you previously received under the contract, multiplied by a fraction. The numerator (top part) is the reduction in each annuity payment because of the nonperiodic distribution. The denominator (bottom part) is the full unreduced amount of each annuity payment originally provided for.

Single-sum in connection with the start of annuity payments. If you receive a single-sum payment on or after your annuity starting date in connection with the start of annuity payments for which you must use the Simplified Method, treat the single-sum payment as if it were received **before** your annuity starting date. (See *Simplified Method* under *Taxation of Periodic Payments*, earlier, for information on its required use.) Follow the rules in the next discussion, *Distribution Before Annuity Starting Date From a Qualified Plan*.

Distribution in full discharge of contract. You may receive an amount on or after the annuity starting date that fully satisfies the payer's obligation under the contract. The amount may be a refund of what you paid for the contract or for the complete surrender, redemption, or maturity of the contract. Include the amount in gross income only to the extent that it exceeds the remaining cost of the contract.

Distribution Before Annuity Starting Date From a Qualified Plan

If you receive a nonperiodic distribution **before** the annuity starting date from a **qualified retirement plan**, you generally can allocate only part of it to the cost of the contract. You exclude from your gross income the part that you allocate to the cost. You include the remainder in your gross income.

For this purpose, a qualified retirement plan is:

- A qualified employee plan (or annuity contract purchased by such a plan),
- A qualified employee annuity plan, or

- A tax-sheltered annuity plan (403(b) plan).

Use the following formula to figure the tax-free amount of the distribution.

$$\text{Amount received} \times \frac{\text{Cost of contract}}{\text{Account balance}} = \text{Tax-free amount}$$

For this purpose, your account balance includes only amounts to which you have a nonforfeitable right (a right that cannot be taken away).

Example. Before she had a right to an annuity, Ann Blake received \$50,000 from her retirement plan. She had \$10,000 invested (cost) in the plan. Her account balance was \$100,000. She can exclude \$5,000 of the \$50,000 distribution, figured as follows:

$$\$50,000 \times \frac{\$10,000}{\$100,000} = \$5,000$$

Defined contribution plan. Under a defined contribution plan, your contributions (and income allocable to them) may be treated as a separate contract for figuring the taxable part of any distribution. A defined contribution plan is a plan in which you have an individual account. Your benefits are based only on the amount contributed to the account and the income, expenses, etc., allocated to the account.

Plans that permitted withdrawal of employee contributions. If you contributed before 1987 to a pension plan that, as of May 5, 1986, permitted you to withdraw your contributions before your separation from service, any distribution before your annuity starting date is tax free to the extent that it, when added to earlier distributions received after 1986, does not exceed your cost as of December 31, 1986. Apply the allocation described in the preceding discussion only to any excess distribution.

Distribution Before Annuity Starting Date From a Nonqualified Plan

If you receive a nonperiodic distribution before the annuity starting date from a plan **other than** a qualified retirement plan, it is allocated first to earnings (the taxable part) and then to the cost of the contract (the tax-free part). This allocation rule applies, for example, to a commercial annuity contract you bought directly from the issuer. You include in your gross income the smaller of:

- The nonperiodic distribution, or
- The amount by which the cash value of the contract (figured without considering any surrender charge) immediately before you receive the distribution exceeds your investment in the contract at that time.

Example. You bought an annuity from an insurance company. Before the annuity starting date under your

annuity contract, you received a \$7,000 distribution. At the time of the distribution, the annuity had a cash value of \$16,000 and your investment in the contract was \$10,000. The distribution is allocated first to earnings, so you must include \$6,000 (\$16,000 – \$10,000) in your gross income. The remaining \$1,000 is a tax-free return of part of your investment.

Exception to allocation rule. Certain nonperiodic distributions received before the annuity starting date are **not** subject to the allocation rule in the preceding discussion. Instead, you include the amount of the payment in gross income only to the extent that it exceeds the cost of the contract.

This exception applies to the following distributions.

- Distributions in full discharge of a contract that you receive as a refund of what you paid for the contract or for the complete surrender, redemption, or maturity of the contract.
- Distributions from life insurance or endowment contracts (other than modified endowment contracts, as defined in section 7702A of the Internal Revenue Code) that are not received as an annuity under the contracts.
- Distributions under contracts entered into before August 14, 1982, to the extent that they are allocable to your investment before August 14, 1982.

If you bought an annuity contract and made investments both before August 14, 1982, and later, the distributed amounts are allocated to your investment or to earnings in the following order.

- 1) The part of your investment that was made before August 14, 1982. This part of the distribution is tax free.
- 2) The earnings on the part of your investment that was made before August 14, 1982. This part of the distribution is taxable.
- 3) The earnings on the part of your investment that was made after August 13, 1982. This part of the distribution is taxable.
- 4) The part of your investment that was made after August 13, 1982. This part of the distribution is tax free.

Distribution of U.S. savings bonds. If you receive U.S. savings bonds in a taxable distribution from a retirement plan, report the value of the bonds at the time of distribution as income. The value of the bonds includes accrued interest. When you cash the bonds, your Form 1099–INT will show the total interest accrued, including the part you reported when the bonds were distributed to you. For information on how to adjust your interest income for U.S. savings bond interest you previously reported, see *How To Report Interest Income* in chapter 1 of Publication 550, *Investment Income and Expenses*.

Loans Treated as Distributions

If you borrow money from your retirement plan, you must treat the loan as a nonperiodic distribution from the plan unless it qualifies for the exception explained below. This treatment also applies to any loan under a contract purchased under your retirement plan, and to the value of any part of your interest in the plan or contract that you pledge or assign (or agree to pledge or assign). It applies to loans from both qualified and nonqualified plans, including commercial annuity contracts you purchase directly from the issuer. Further, it applies if you renegotiate, extend, renew, or revise a loan that qualified for the exception below if the altered loan does not qualify. In that situation, you must treat the outstanding balance of the loan as a distribution on the date of the transaction.

You determine how much of the loan is taxable using the allocation rules for nonperiodic distributions discussed under *Figuring the Taxable Amount*, earlier. The taxable part may be subject to the additional tax on early distributions. It is not an eligible rollover distribution and does not qualify for the 10-year tax option.

Exception for qualified plan, 403(b) plan, and government plan loans. At least part of certain loans under a qualified employee plan, qualified employee annuity, tax-sheltered annuity (403(b) plan), or government plan is not treated as a distribution from the plan. This exception applies only to a loan that either:

- Is used to buy your main home, or
- Must be repaid within 5 years.

To qualify for this exception, the loan must require substantially level payments at least quarterly over the life of the loan.

If a loan qualifies for this exception, you must treat it as a nonperiodic distribution only to the extent that the loan, when added to the outstanding balances of all your loans from all plans of your employer (and certain related employers) exceeds the lesser of:

- \$50,000, or
- Half the present value (but not less than \$10,000) of your nonforfeitable accrued benefit under the plan, determined without regard to any accumulated deductible employee contributions.

You must reduce the \$50,000 amount above if you already had an outstanding loan from the plan during the 1-year period ending the day before you took out the loan. The amount of the reduction is your highest outstanding loan balance during that period minus the outstanding balance on the date you took out the new loan. If this amount is zero or less, ignore it.

Related employers and related plans. Treat separate employers' plans as plans of a single employer if they are treated that way under other qualified retirement plan rules because the employers are related. You must treat all plans of a single employer as one plan.

Employers are related if they are:

- Members of a controlled group of corporations,
- Businesses under common control, or
- Members of an affiliated service group.

An affiliated service group generally is two or more service organizations whose relationship involves an ownership connection. Their relationship also includes the regular or significant performance of services by one organization for or in association with another.

Denial of interest deduction. If the loan from a qualified plan is not treated as a distribution because the exception applies, you cannot deduct any of the interest on the loan during any period that:

- The loan is secured by amounts from elective deferrals under a qualified cash or deferred arrangement (section 401(k) plan) or a salary reduction agreement to purchase a tax-sheltered annuity, or
- You are a key employee as defined in section 416(i) of the Internal Revenue Code.

Reporting by plan. If your loan is treated as a distribution, you should receive a Form 1099-R showing code "L" in box 7.

Effect on investment in the contract. If you receive a loan under a qualified plan (a qualified employee plan or qualified employee annuity) or tax-sheltered annuity plan (403(b) plan) that is treated as a nonperiodic distribution, you must reduce your investment in the contract to the extent that the distribution is tax free under the allocation rules for qualified plans explained earlier. Repayments of the loan increase your investment in the contract to the extent that the distribution is taxable under those rules.

If you receive a loan under a nonqualified plan other than a 403(b) plan, including a commercial annuity contract that you purchase directly from the issuer, you increase your investment in the contract to the extent that the distribution is taxable under the general allocation rule for nonqualified plans explained earlier. Repayments of the loan do not affect your investment in the contract. However, if the distribution is excepted from the general allocation rule (for example, because it is made under a contract entered into before August 14, 1982), you reduce your investment in the contract to the extent that the distribution is tax free and increase it for loan repayments to the extent that the distribution is taxable.

Transfers of Annuity Contracts

If you transfer without full and adequate consideration an annuity contract issued after April 22, 1987, you are treated as receiving a nonperiodic distribution. The distribution equals the excess of:

- The cash surrender value of the contract at the time of transfer, over
- Your investment in the contract at that time.

This rule does not apply to transfers between spouses or transfers incident to a divorce.

Tax-free exchange. No gain or loss is recognized on an exchange of an annuity contract for another annuity contract if the insured or annuitant remains the same. However, if an annuity contract is exchanged for a life insurance or endowment contract, any gain due to interest accumulated on the contract is ordinary income.

If you transfer a full or partial interest in a tax-sheltered annuity that is not subject to restrictions on early distributions to another tax-sheltered annuity, the transfer qualifies for nonrecognition of gain or loss.

If you exchange an annuity contract issued by a life insurance company that is subject to a rehabilitation, conservatorship, or similar state proceeding for an annuity contract issued by another life insurance company, the exchange qualifies for nonrecognition of gain or loss. The exchange is tax free even if the new contract is funded by two or more payments from the old annuity contract. This also applies to an exchange of a life insurance contract for a life insurance, endowment, or annuity contract.

In general, a transfer or exchange in which you receive **cash proceeds** from the surrender of one contract and invest the cash in another contract does not qualify for nonrecognition of gain or loss. However, no gain or loss is recognized if the cash distribution is from an insurance company that is subject to a rehabilitation, conservatorship, insolvency, or similar state proceeding. For the nonrecognition rule to apply, you must also reinvest the proceeds in a single contract issued by another insurance company and the exchange of the contracts must otherwise qualify for nonrecognition. You must withdraw all the cash you can and reinvest it within 60 days. If the cash distribution is less than required for full settlement, you must assign all rights to any future distributions to the new issuer.

If you want nonrecognition treatment for the cash distribution, you must give the new issuer the following information.

- The amount of cash distributed.
- The amount of the cash reinvested in the new contract.
- The amount of your investment in the old contract on the date of the initial distribution.

You must attach the following items to your timely filed income tax return for the year of the initial distribution.

- A copy of the statement you gave to the new issuer.
- A statement that contains the words “ELECTION UNDER REV. PROC. 92–44,” the new issuer’s name, and the policy number or similar identifying information for the new contract.

Tax-free exchange reported on Form 1099–R. If you make a tax-free exchange of an annuity contract for another annuity contract issued by a different company, the

exchange will be shown on Form 1099–R with a code “6” in box 7. You need not report this on your tax return.

Treatment of contract received. If you acquire an annuity contract in a tax-free exchange for another annuity contract, its date of purchase is the date you purchased the annuity you exchanged. This rule applies for determining if the annuity qualifies for exemption from the tax on early distributions as an immediate annuity.

Lump-Sum Distributions

If you receive a lump-sum distribution from a qualified employee plan or qualified employee annuity and the plan participant was born before 1936, you may be able to elect optional methods of figuring the tax on the distribution. The part from active participation in the plan before 1974 may qualify as capital gain subject to a 20% tax rate. The part from participation after 1973 (and any part from participation before 1974 that you do not report as capital gain) is ordinary income. You may be able to use the 10-year tax option, discussed later, to figure tax on the ordinary income part.

Each individual, estate, or trust who receives part of a lump-sum distribution on behalf of a plan participant who was born before 1936 can choose whether to elect the optional methods for the part each received. However, if two or more trusts receive the distribution, the plan participant or the personal representative of a deceased participant must make the choice.

Use **Form 4972**, to figure the separate tax on a lump-sum distribution using the optional methods. The tax figured on Form 4972 is added to the regular tax figured on your other income. This may result in a smaller tax than you would pay by including the taxable amount of the distribution as ordinary income in figuring your regular tax.

Alternate payee under qualified domestic relations order. If you receive a distribution as an alternate payee under a qualified domestic relations order (discussed earlier under *General Information*), you may be able to choose the optional tax computations for it. You can make this choice for a distribution that would be treated as a lump-sum distribution had it been received by your spouse or former spouse (the plan participant). However, for this purpose, the balance to your credit does not include any amount payable to the plan participant.

If you choose an optional tax computation for a distribution received as an alternate payee, this choice will not affect any election for distributions from your own plan.

More than one recipient. One or all of the recipients of a lump-sum distribution can use the optional tax computations. See *Multiple recipients of a lump-sum distribution* in the instructions for Form 4972.

Lump-sum distribution defined. A lump-sum distribution is the distribution or payment in 1 tax year of a plan participant’s entire balance from all of the employer’s qualified plans of one kind (for example, pension, profit-sharing, or stock bonus plans). A distribution from a nonqualified plan (such as a privately purchased commercial annuity or a section 457 deferred compensation plan of a state or

local government or tax-exempt organization) cannot qualify as a lump-sum distribution.

The participant's entire balance from a plan does not include certain forfeited amounts. It also does not include any deductible voluntary employee contributions allowed by the plan after 1981 and before 1987.

Reemployment. A separated employee's vested percentage in his or her retirement benefit may increase if he or she is rehired by the employer within 5 years following separation from service. This possibility does not prevent a distribution made before reemployment from qualifying as a lump-sum distribution. However, if the employee elected an optional method of figuring the tax on the distribution and his or her vested percentage in the previous retirement benefit increases after reemployment, the employee must recapture the tax saved. This is done by increasing the tax for the year in which the increase in vesting first occurs.

Distributions that do not qualify. The following distributions do not qualify as lump-sum distributions for the capital gain treatment or 10-year tax option.

- Any distribution that is partially rolled over to another qualified plan or an IRA.
- Any distribution if an earlier election to use either the 5- or 10-year tax option had been made after 1986 for the same plan participant.
- U.S. Retirement Plan Bonds distributed with a lump sum.
- Any distribution made during the first 5 tax years that the participant was in the plan, unless it was made because the participant died.
- The current actuarial value of any annuity contract included in the lump sum. (The payer's statement should show this amount, which you use only to figure tax on the ordinary income part of the distribution.)
- Any distribution to a 5% owner that is subject to penalties under section 72(m)(5)(A) of the Internal Revenue Code.
- A distribution from an IRA.
- A distribution from a tax-sheltered annuity (section 403(b) plan).
- A distribution of the redemption proceeds of bonds rolled over tax free to a qualified pension plan, etc., from a qualified bond purchase plan.
- A distribution from a qualified plan if the participant or his or her surviving spouse previously received an eligible rollover distribution from the same plan (or another plan of the employer that must be combined with that plan for the lump-sum distribution rules) and the previous distribution was rolled over tax free to another qualified plan or an IRA.
- A distribution from a qualified plan that received a rollover after 2001 from an IRA (other than a conduit IRA), a governmental section 457 plan, or a section

403(b) tax-sheltered annuity on behalf of the plan participant.

- A distribution from a qualified plan that received a rollover after 2001 from another qualified plan on behalf of that plan participant's surviving spouse.
- A corrective distribution of excess deferrals, excess contributions, excess aggregate contributions, or excess annual additions.
- A lump-sum credit or payment from the Federal Civil Service Retirement System (or the Federal Employees' Retirement System).

How to treat the distribution. If you receive a lump-sum distribution, you may have the following options for how you treat the taxable part.

- Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and the part from participation after 1973 as ordinary income.
- Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and use the 10-year tax option to figure the tax on the part from participation after 1973 (if you qualify).
- Use the 10-year tax option to figure the tax on the total taxable amount (if you qualify).
- Roll over all or part of the distribution. See *Rollovers*, later. No tax is currently due on the part rolled over. Report any part not rolled over as ordinary income.
- Report the entire taxable part of the distribution as ordinary income on your tax return.

The first three options are explained in the following discussions.

Electing optional lump-sum treatment. You can choose to use the 10-year tax option or capital gain treatment only once after 1986 for any plan participant. If you make this choice, you cannot use either of these optional treatments for any future distributions for the participant.

Complete Form 4972 and attach it to your Form 1040 if you choose to use the tax options. If you received more than one lump-sum distribution for a plan participant during the year, you must add them together in your computation. If you and your spouse are filing a joint return and you both have received a lump-sum distribution, each of you should complete a separate Form 4972.

Time for choosing. You must decide to use the tax options before the end of the time, including extensions, for making a claim for credit or refund of tax. This is usually 3 years after the date the return was filed or 2 years after the date the tax was paid, whichever is later. (Returns filed before their due date are considered filed on their due date.)

Changing your mind. You can change your mind and decide not to use the tax options within the time period just discussed. If you change your mind, file Form 1040X,

Amended U.S. Individual Income Tax Return, with a statement saying you do not want to use the optional lump-sum treatment. You must pay any additional tax due to the change with the Form 1040X.

How to report. If you elect capital gain treatment (but not the 10-year tax option) for a lump-sum distribution, include the ordinary income part of the distribution on lines 16a and 16b of Form 1040. Enter the capital gain part of the distribution in Part II of Form 4972.

If you elect the 10-year tax option, do not include any part of the distribution on lines 16a or 16b of Form 1040. Report the entire distribution in Part III of Form 4972 or, if you also elect capital gain treatment, report the capital gain part in Part II and the ordinary income part in Part III.

Include the tax from line 30 of Form 4972 on line 42 of Form 1040.

Taxable and tax-free parts of the distribution. The taxable part of a lump-sum distribution is the employer's contributions and income earned on your account. You may recover your **cost** in the lump sum and any **net unrealized appreciation (NUA)** in employer securities tax free.

Cost. In general, your cost is the total of:

- The plan participant's nondeductible contributions to the plan,
- The plan participant's taxable costs of any life insurance contract distributed,
- Any employer contributions that were taxable to the plan participant, and
- Repayments of any loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

NUA. The NUA in employer securities (box 6 of Form 1099-R) received as part of a lump-sum distribution is generally tax free until you sell or exchange the securities. (See *Distributions of employer securities* under *Figuring the Taxable Amount*, earlier.) However, if you choose to include the NUA in your income for the year of the distribution and there is an amount in box 3 of Form 1099-R, part of the NUA will qualify for capital gain treatment. Use the *NUA Worksheet* in the instructions for Form 4972 to find the part that qualifies.

Losses. You may be able to claim a loss on your return if you receive a lump-sum distribution that is less than the plan participant's cost. You must receive the distribution entirely in cash or worthless securities. The amount you can claim is the difference between the participant's cost and the amount of the cash distribution, if any.

To claim the loss, you must itemize deductions on Schedule A (Form 1040). Show the loss as a miscellaneous deduction subject to the 2%-of-adjusted-gross-income limit.

You cannot claim a loss if you receive securities that are not worthless, even if the total value of the distribution is

less than the plan participant's cost. You recognize gain or loss only when you sell or exchange the securities.

Capital Gain Treatment

Capital gain treatment applies only to the taxable part of a lump-sum distribution resulting from participation in the plan before 1974. The amount treated as capital gain is taxed at a 20% rate. You can elect this treatment only once for any plan participant, and only if the plan participant was born before 1936.

Complete Part II of Form 4972 to choose the 20% capital gain election.

Figuring the capital gain and ordinary income parts. Generally, figure the capital gain and ordinary income parts of a lump-sum distribution by using the following formulas.

Capital Gain:

$$\begin{array}{r} \text{Total} \\ \text{Taxable} \quad \times \quad \frac{\text{Months of active participation before 1974}}{\text{Total months of active participation}} \\ \text{Amount} \end{array}$$

Ordinary Income:

$$\begin{array}{r} \text{Total} \\ \text{Taxable} \quad \times \quad \frac{\text{Months of active participation after 1973}}{\text{Total months of active participation}} \\ \text{Amount} \end{array}$$

In figuring the months of active participation before 1974, count as 12 months any part of a calendar year in which the plan participant actively participated under the plan. For active participation after 1973, count as one month any part of a calendar month in which the participant actively participated in the plan.

The capital gain part should be shown in box 3 of Form 1099-R or other statement given to you by the payer of the distribution.

Reduction for federal estate tax. If any federal estate tax (discussed under *Survivors and Beneficiaries*, later) was paid on the lump-sum distribution, you must decrease the capital gain by the amount of estate tax applicable to it. Follow the Form 4972 instructions for Part II, line 6, to figure the part of the estate tax applicable to the capital gain and the part applicable to the ordinary income. If you do not make the capital gain election, enter on line 18 of Part III the estate tax attributable to both parts of the lump-sum distribution. For information on how to figure the estate tax attributable to the lump-sum distribution, get the instructions for Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, or contact the administrator of the decedent's estate.

10-Year Tax Option

The 10-year tax option is a special formula used to figure a separate tax on the ordinary income part of a lump-sum distribution. You pay the tax only once, for the year in which you receive the distribution, not over the next 10

years. You can elect this treatment only once for any plan participant, and only if the plan participant was born before 1936.

The ordinary income part of the distribution is the amount shown in box 2a of the Form 1099-R given to you by the payer, minus the amount, if any, shown in box 3. You can also treat the capital gain part of the distribution (box 3 of Form 1099-R) as ordinary income for the 10-year tax option if you do **not** choose capital gain treatment for that part.

Complete Part III of Form 4972 to choose the 10-year tax option. You must use the special tax rates shown in the instructions for Part III to figure the tax.

Examples

The following examples show how to figure the separate tax on Form 4972.

Example 1. Robert Smith, who was born in 1933, retired from Crabtree Corporation in 2002. He withdrew the entire amount to his credit from the company's qualified pension plan. In December 2002, he received a total distribution of \$175,000 (\$25,000 of employee contributions plus \$150,000 of employer contributions and earnings on all contributions).

The payer gave Robert a Form 1099-R, which shows the capital gain part of the distribution (the part attributable

to participation before 1974) to be \$10,000. Robert elects 20% capital gain treatment for this part. A filled-in copy of Robert's Form 1099-R and Form 4972 follows. He enters \$10,000 on Form 4972, Part II, line 6, and \$2,000 (\$10,000 × 20%) on Part II, line 7.

The ordinary income part of the distribution is \$140,000 (\$150,000 minus \$10,000). Robert elects to figure the tax on this part using the 10-year tax option. He enters \$140,000 on Form 4972, Part III, line 8. Then he completes the rest of Form 4972 and includes the tax of \$24,270 in the total on line 42 of his Form 1040.

Example 2. Mary Brown, who was born in 1935, sold her business in 2002. She withdrew her entire interest in the qualified profit-sharing plan she had set up as the sole proprietor.

The cash part of the distribution, \$160,000, is all ordinary income and is shown on her Form 1099-R (see page 22). She chooses to figure the tax on this amount using the 10-year tax option. Mary also received an annuity contract as part of the distribution from the plan. Box 8, Form 1099-R, shows that the current actuarial value of the annuity was \$10,000. She enters these figures on Form 4972 (see page 23).

After completing Form 4972, she includes the tax of \$28,070 in the total on line 42, Form 1040.

CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code <i>Crabtree Corporation Employees' Pension Plan 1111 Main Street Anytown, Texas 75000</i>		1 Gross distribution OMB No. 1545-0119 \$ 175000.00	2002 Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Copy B Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return. This information is being furnished to the Internal Revenue Service.	
		2a Taxable amount \$ 150000.00			
		2b Taxable amount not determined <input type="checkbox"/>	Total distribution <input checked="" type="checkbox"/>		
PAYER'S Federal identification number 10-0000000	RECIPIENT'S identification number 002-00-3456	3 Capital gain (included in box 2a) \$ 10000.00	4 Federal income tax withheld \$ 30000.00		
RECIPIENT'S name Robert C. Smith Street address (including apt. no.) 911 Mill Way City, state, and ZIP code Anytown, Texas 75000		5 Employee contributions or insurance premiums \$ 25000.00	6 Net unrealized appreciation in employer's securities \$		
		7 Distribution code 7A	8 Other \$ %		
		9a Your percentage of total distribution %	9b Total employee contributions \$		
Account number (optional)		10 State tax withheld \$	11 State/Payer's state no.		12 State distribution \$
		13 Local tax withheld \$	14 Name of locality		15 Local distribution \$

Form 1099-R

Department of the Treasury - Internal Revenue Service

Tax on Lump-Sum Distributions
(From Qualified Plans of Participants Born Before 1936)

▶ Attach to Form 1040 or Form 1041.

Name of recipient of distribution

Robert C. Smith

Identifying number
002-00-3456

Part I Complete this part to see if you can use Form 4972

	Yes	No
1 Was this a distribution of a plan participant's entire balance (excluding deductible voluntary employee contributions and certain forfeited amounts) from all of an employer's qualified plans of one kind (pension, profit-sharing, or stock bonus)? If "No," do not use this form	✓	
2 Did you roll over any part of the distribution? If "Yes," do not use this form		✓
3 Was this distribution paid to you as a beneficiary of a plan participant who was born before 1936?		✓
4 Were you (a) a plan participant who received this distribution, (b) born before 1936, and (c) a participant in the plan for at least 5 years before the year of the distribution?	✓	
If you answered "No" to both questions 3 and 4, do not use this form.		
5a Did you use Form 4972 after 1986 for a previous distribution from your own plan? If "Yes," do not use this form for a 2002 distribution from your own plan		✓
b If you are receiving this distribution as a beneficiary of a plan participant who died, did you use Form 4972 for a previous distribution received for that participant after 1986? If "Yes," do not use the form for this distribution.		
5b		

Part II Complete this part to choose the 20% capital gain election (see instructions)

6 Capital gain part from Form 1099-R, box 3	6	10,000	
7 Multiply line 6 by 20% (.20) ▶	7	2,000	
If you also choose to use Part III, go to line 8. Otherwise, include the amount from line 7 in the total on Form 1040, line 42, or Form 1041, Schedule G, line 1b, whichever applies.			

Part III Complete this part to choose the 10-year tax option (see instructions)

8 Ordinary income from Form 1099-R, box 2a minus box 3. If you did not complete Part II, enter the taxable amount from Form 1099-R, box 2a	8	140,000	
9 Death benefit exclusion for a beneficiary of a plan participant who died before August 21, 1996	9		
10 Total taxable amount. Subtract line 9 from line 8	10	140,000	
11 Current actuarial value of annuity from Form 1099-R, box 8. If none, enter -0-	11	-0-	
12 Adjusted total taxable amount. Add lines 10 and 11. If this amount is \$70,000 or more, skip lines 13 through 16, enter this amount on line 17, and go to line 18	12	140,000	
13 Multiply line 12 by 50% (.50), but do not enter more than \$10,000	13		
14 Subtract \$20,000 from line 12. If line 12 is \$20,000 or less, enter -0-	14		
15 Multiply line 14 by 20% (.20)	15		
16 Minimum distribution allowance. Subtract line 15 from line 13	16		
17 Subtract line 16 from line 12	17	140,000	
18 Federal estate tax attributable to lump-sum distribution	18		
19 Subtract line 18 from line 17. If line 11 is zero, skip lines 20 through 22 and go to line 23	19	140,000	
20 Divide line 11 by line 12 and enter the result as a decimal (rounded to at least three places)	20	.	
21 Multiply line 16 by the decimal on line 20	21		
22 Subtract line 21 from line 11	22		
23 Multiply line 19 by 10% (.10)	23	14,000	
24 Tax on amount on line 23. Use the Tax Rate Schedule in the instructions	24	2,227	
25 Multiply line 24 by ten (10). If line 11 is zero, skip lines 26 through 28, enter this amount on line 29, and go to line 30	25	22,270	
26 Multiply line 22 by 10% (.10)	26		
27 Tax on amount on line 26. Use the Tax Rate Schedule in the instructions	27		
28 Multiply line 27 by ten (10)	28		
29 Subtract line 28 from line 25. (Multiple recipients, see instructions.) ▶	29	22,270	
30 Tax on lump-sum distribution. Add lines 7 and 29. Also include this amount in the total on Form 1040, line 42, or Form 1041, Schedule G, line 1b, whichever applies ▶	30	24,270	

CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code Brown's Real Estate Profit-Sharing Plan 2101 Chelsea Court Anytown, Nevada 89300		1 Gross distribution \$ 160000.00		OMB No. 1545-0119 2002 Form 1099-R		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
		2a Taxable amount \$ 160000.00		2b Taxable amount not determined <input type="checkbox"/> Total distribution <input checked="" type="checkbox"/>		
PAYER'S Federal identification number 10-0000000	RECIPIENT'S identification number 005-00-6789	3 Capital gain (included in box 2a) \$		4 Federal income tax withheld \$ 32000.00		Copy B Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return. This information is being furnished to the Internal Revenue Service.
RECIPIENT'S name Mary Brown Street address (including apt. no.) 12 Mill Avenue City, state, and ZIP code Anytown, Nevada 89300		5 Employee contributions or insurance premiums \$		6 Net unrealized appreciation in employer's securities \$		
		7 Distribution code 7A	IRA/SEP/SIMPLE <input type="checkbox"/>	8 Other \$ 10000.00 %	9a Your percentage of total distribution % %	
Account number (optional)		9b Total employee contributions \$		10 State tax withheld \$ \$		11 State/Payer's state no. ----- \$ \$
		13 Local tax withheld \$ \$		14 Name of locality ----- \$ \$		12 State distribution \$ \$
						15 Local distribution \$ \$

Form **1099-R**

Department of the Treasury - Internal Revenue Service

Tax on Lump-Sum Distributions
(From Qualified Plans of Participants Born Before 1936)

▶ Attach to Form 1040 or Form 1041.

Name of recipient of distribution

Mary Brown

Identifying number

005-00-6789

Part I Complete this part to see if you can use Form 4972

	Yes	No
1 Was this a distribution of a plan participant's entire balance (excluding deductible voluntary employee contributions and certain forfeited amounts) from all of an employer's qualified plans of one kind (pension, profit-sharing, or stock bonus)? If "No," do not use this form.	✓	
2 Did you roll over any part of the distribution? If "Yes," do not use this form.		✓
3 Was this distribution paid to you as a beneficiary of a plan participant who was born before 1936?		✓
4 Were you (a) a plan participant who received this distribution, (b) born before 1936, and (c) a participant in the plan for at least 5 years before the year of the distribution? If you answered "No" to both questions 3 and 4, do not use this form.	✓	
5a Did you use Form 4972 after 1986 for a previous distribution from your own plan? If "Yes," do not use this form for a 2002 distribution from your own plan.		✓
5b If you are receiving this distribution as a beneficiary of a plan participant who died, did you use Form 4972 for a previous distribution received for that participant after 1986? If "Yes," do not use the form for this distribution.		

Part II Complete this part to choose the 20% capital gain election (see instructions)

6 Capital gain part from Form 1099-R, box 3.	6		
7 Multiply line 6 by 20% (.20) ▶	7		
If you also choose to use Part III, go to line 8. Otherwise, include the amount from line 7 in the total on Form 1040, line 42, or Form 1041, Schedule G, line 1b, whichever applies.			

Part III Complete this part to choose the 10-year tax option (see instructions)

8 Ordinary income from Form 1099-R, box 2a minus box 3. If you did not complete Part II, enter the taxable amount from Form 1099-R, box 2a.	8	160,000	
9 Death benefit exclusion for a beneficiary of a plan participant who died before August 21, 1996	9		
10 Total taxable amount. Subtract line 9 from line 8	10	160,000	
11 Current actuarial value of annuity from Form 1099-R, box 8. If none, enter -0-	11	10,000	
12 Adjusted total taxable amount. Add lines 10 and 11. If this amount is \$70,000 or more, skip lines 13 through 16, enter this amount on line 17, and go to line 18	12	170,000	
13 Multiply line 12 by 50% (.50), but do not enter more than \$10,000.	13		
14 Subtract \$20,000 from line 12. If line 12 is \$20,000 or less, enter -0-	14		
15 Multiply line 14 by 20% (.20)	15		
16 Minimum distribution allowance. Subtract line 15 from line 13	16		
17 Subtract line 16 from line 12	17	170,000	
18 Federal estate tax attributable to lump-sum distribution	18		
19 Subtract line 18 from line 17. If line 11 is zero, skip lines 20 through 22 and go to line 23	19	170,000	
20 Divide line 11 by line 12 and enter the result as a decimal (rounded to at least three places)	20	.0588	
21 Multiply line 16 by the decimal on line 20	21		
22 Subtract line 21 from line 11	22	10,000	
23 Multiply line 19 by 10% (.10)	23	17,000	
24 Tax on amount on line 23. Use the Tax Rate Schedule in the instructions	24	2,917	
25 Multiply line 24 by ten (10). If line 11 is zero, skip lines 26 through 28, enter this amount on line 29, and go to line 30	25	29,170	
26 Multiply line 22 by 10% (.10)	26	1,000	
27 Tax on amount on line 26. Use the Tax Rate Schedule in the instructions	27	110	
28 Multiply line 27 by ten (10)	28	1,100	
29 Subtract line 28 from line 25. (Multiple recipients, see instructions.) ▶	29	28,070	
30 Tax on lump-sum distribution. Add lines 7 and 29. Also include this amount in the total on Form 1040, line 42, or Form 1041, Schedule G, line 1b, whichever applies ▶	30	28,070	

Rollovers

If you withdraw cash or other assets from a qualified retirement plan in an eligible rollover distribution, you can defer tax on the distribution by rolling it over to another qualified retirement plan or a traditional IRA. You do not include the amount rolled over in your income until you receive it in a distribution from the recipient plan or IRA without rolling over that distribution. (For information about rollovers from traditional IRAs, see chapter 1 of Publication 590.)

If you roll over the distribution to a traditional IRA, you cannot deduct the amount rolled over as an IRA contribution. When you later withdraw it from the IRA, you cannot use the optional methods discussed earlier under *Lump-Sum Distributions* to figure the tax.

Self-employed individuals are generally treated as employees for the rules on the tax treatment of distributions, including the rules for rollovers.

Qualified retirement plan. For this purpose, the following plans are qualified retirement plans.

- A qualified employee plan.
- A qualified employee annuity.
- A tax-sheltered annuity plan (403(b) plan).
- An eligible state or local government section 457 deferred compensation plan.

Eligible rollover distribution. An eligible rollover distribution is any distribution of all or any part of the balance to your credit in a qualified retirement plan **except**:

- 1) Any of a series of substantially equal distributions paid at least once a year over:
 - a) Your lifetime or life expectancy,
 - b) The joint lives or life expectancies of you and your beneficiary, or
 - c) A period of 10 years or more,
- 2) A required minimum distribution (discussed later under *Tax on Excess Accumulation*),
- 3) Hardship distributions,
- 4) Corrective distributions of excess contributions or excess deferrals, and any income allocable to the excess, or of excess annual additions and any allocable gains (see *Corrective distributions of excess plan contributions*, at the beginning of *Taxation of Nonperiodic Payments*, earlier),
- 5) A loan treated as a distribution because it does not satisfy certain requirements either when made or later (such as upon default), unless the participant's accrued benefits are reduced (offset) to repay the loan (see *Loans Treated as Distributions*, earlier),
- 6) Dividends on employer securities, and

- 7) The cost of life insurance coverage.

In addition, a distribution to the plan participant's beneficiary generally is not treated as an eligible rollover distribution. However, see *Qualified domestic relations order* and *Rollover by surviving spouse*, later.

Rollover of nontaxable amounts. You may be able to roll over the nontaxable part of a distribution (such as your after-tax contributions) made to another qualified retirement plan or traditional IRA. The transfer must be made either through a direct rollover to a qualified plan that separately accounts for the taxable and nontaxable parts of the rollover or through a rollover to a traditional IRA.

If you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll over is treated as coming first from the taxable part of the distribution.

Withholding requirements. If an eligible rollover distribution is paid to you, the payer must withhold 20% of it. This applies even if you plan to roll over the distribution to another qualified retirement plan or to an IRA. However, you can avoid withholding by choosing the **direct rollover option**, discussed later. Also, see *Choosing the right option* at the end of this discussion.

Exceptions. An eligible rollover distribution is not subject to withholding to the extent it consists of net unrealized appreciation from employer securities that can be excluded from your gross income. (For a discussion of the tax treatment of a distribution of employer securities, see *Figuring the Taxable Amount* under *Taxation of Nonperiodic Payments*, earlier.)

In addition, withholding from an eligible rollover distribution paid to you is not required if:

- The distribution and all previous eligible rollover distributions you received during the tax year from the same plan (or, at the payer's option, from all your employer's plans) total less than \$200, or
- The distribution consists solely of employer securities, plus cash of \$200 or less in lieu of fractional shares.

Direct rollover option. You can choose to have any part or all of an eligible rollover distribution paid directly to another qualified retirement plan that accepts rollover distributions or to a traditional IRA.

No tax withheld. If you choose the direct rollover option, no tax will be withheld from any part of the distribution that is directly paid to the trustee of the other plan. If any part of the eligible rollover distribution is paid to you, the payer must generally withhold 20% of it for income tax.

Payment to you option. If an eligible rollover distribution is paid to you, 20% generally will be withheld for income tax. However, the full amount is treated as distributed to you even though you actually receive only 80%. You generally must include in income any part (including the part withheld) that you do not roll over within 60 days to another qualified retirement plan or to a traditional IRA.

If you are under age 59½ when a distribution is paid to you, you may have to pay a 10% tax (in addition to the regular income tax) on the taxable part (including any tax withheld) that you do not roll over. See *Tax on Early Distributions*, later.

Partial rollovers. If you receive a lump-sum distribution, it may qualify for special tax treatment. See *Lump-Sum Distributions*, earlier. However, if you roll over any part of the distribution, the part you keep does **not** qualify for special tax treatment.



Rolling over more than amount received. If the part of the distribution you want to roll over exceeds (due to the tax withholding) the amount you actually received, you will have to get funds from some other source (such as your savings or borrowed amounts) to add to the amount you actually received.

Example. You receive an eligible rollover distribution of \$10,000 from your employer's qualified employee plan. The payer withholds \$2,000, so you actually receive \$8,000. If you want to roll over the entire \$10,000 to postpone including that amount in your income, you will have to get \$2,000 from some other source to add to the \$8,000 you actually received.

If you roll over only \$8,000, you must include the \$2,000 not rolled over in your income for the distribution year. Also, you may be subject to the 10% additional tax on the \$2,000 if it was distributed to you before you reached age 59½.

Time for making rollover. You generally must complete the rollover of an eligible rollover distribution paid to you by the 60th day following the day on which you receive the distribution from your employer's plan.

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

Example. In the previous example, you received the distribution on June 30, 2003. To postpone including it in your income, you must complete the rollover by August 29, 2003, the 60th day following June 30.

Frozen deposits. If an amount distributed to you becomes a frozen deposit in a financial institution during the 60-day period after you receive it, the rollover period is extended. An amount is a frozen deposit if you cannot withdraw it because of either:

- The bankruptcy or insolvency of the financial institution, or
- A restriction on withdrawals by the state in which the institution is located because of the bankruptcy or insolvency (or threat of it) of one or more financial institutions in the state.

The 60-day rollover period is extended by the period for which the amount is a frozen deposit and does not end earlier than 10 days after the amount is no longer a frozen deposit.

Retirement bonds. If you redeem retirement bonds purchased under a qualified bond purchase plan, you can roll over the proceeds that exceed your basis tax free into an IRA or qualified employer plan. Subsequent distributions of those proceeds, however, do not qualify for the 10-year tax option or capital gain treatment.

Annuity contracts. If an annuity contract was distributed to you by a qualified retirement plan, you can roll over an amount paid under the contract that is otherwise an eligible rollover distribution. For example, you can roll over a single sum payment you receive upon surrender of the contract to the extent it is taxable and is not a required minimum distribution.

Rollovers of property. To roll over an eligible rollover distribution of property, you must either roll over the actual property distributed or sell it and roll over the proceeds. You cannot keep the distributed property and roll over cash or other property.

If you sell the distributed property and roll over all the proceeds, no gain or loss is recognized on the sale. The sale proceeds (including any portion representing an increase in value) are treated as part of the distribution and are not included in your gross income.

If you roll over only part of the proceeds, you are taxed on the part you keep. You must allocate the proceeds you keep between the part representing ordinary income from the distribution (its value upon distribution) and the part representing gain or loss from the sale (its change in value from its distribution to its sale).

Example 1. On September 6, 2002, Paul received an eligible rollover distribution from his employer's noncontributory qualified employee plan of \$50,000 in nonemployer stock. On September 27, 2002, he sold the stock for \$60,000. On October 4, 2002, he contributed \$60,000 cash to a traditional IRA. Paul does not include either the \$50,000 eligible rollover distribution or the \$10,000 gain from the sale of the stock in his income. The entire \$60,000 rolled over will be ordinary income when he withdraws it from his IRA.

Example 2. The facts are the same as in Example 1, except that Paul sold the stock for \$40,000 and contributed \$40,000 to the IRA. Paul does not include the \$50,000 eligible rollover distribution in his income and does not deduct the \$10,000 loss from the sale of the stock. The \$40,000 rolled over will be ordinary income when he withdraws it from his IRA.

Example 3. The facts are the same as in Example 1, except that Paul rolled over only \$45,000 of the \$60,000 proceeds from the sale of the stock. The \$15,000 proceeds he did not roll over includes part of the gain from the stock sale. Paul reports \$2,500 ($\$10,000/\$60,000 \times \$15,000$) as capital gain and \$12,500 ($\$50,000/\$60,000 \times \$15,000$) as ordinary income.

Example 4. The facts are the same as in Example 2, except that Paul rolled over only \$25,000 of the \$40,000 proceeds from the sale of the stock. The \$15,000 proceeds

he did not roll over includes part of the loss from the stock sale. Paul reports \$3,750 ($\$10,000/\$40,000 \times \$15,000$) capital loss and \$18,750 ($\$50,000/\$40,000 \times \$15,000$) ordinary income.

Property and cash distributed. If both cash and property were distributed and you did not roll over the entire distribution, you may designate what part of the rollover is allocable to the cash distribution and what part is allocable to the proceeds from the sale of the distributed property. If the distribution included an amount that is not taxable (other than the net unrealized appreciation in employer securities) as well as an eligible rollover distribution, you may also designate what part of the nontaxable amount is allocable to the cash distribution and what part is allocable to the property. Your designation must be made by the due date for filing your tax return, including extensions. You cannot change your designation after that date. If you do not make a designation on time, the rollover amount or the nontaxable amount must be allocated on a ratable basis.

Qualified domestic relations order (QDRO). You may be able to roll over tax free all or part of a distribution from a qualified retirement plan that you receive under a QDRO. (See *Qualified domestic relations order (QDRO)* under *General Information*, earlier.) If you receive the distribution as an employee's spouse or former spouse (not as a nonspousal beneficiary), the rollover rules apply to you as if you were the employee.

Rollover by surviving spouse. You may be able to roll over tax free all or part of a distribution from a qualified retirement plan you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee. You can roll over the distribution into a qualified retirement plan or a traditional IRA.

A distribution paid to a beneficiary other than the employee's surviving spouse is not an eligible rollover distribution.

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

Written explanation to recipients. The administrator of a qualified retirement plan must, within a reasonable period of time before making an eligible rollover distribution, provide you with a written explanation. It must tell you about all of the following.

- Your right to have the distribution paid tax free directly to another qualified retirement plan or to a traditional IRA.
- The requirement to withhold tax from the distribution if it is not directly rolled over.

- The nontaxability of any part of the distribution that you roll over within 60 days after you receive the distribution.
- Other qualified retirement plan rules that apply, including those for lump-sum distributions, alternate payees, and cash or deferred arrangements.
- How the distribution rules of the plan to which you roll over the distribution may differ from the rules that apply to the plan making the distribution in their restrictions and tax consequences.

Reasonable period of time. The plan administrator must provide you with a written explanation no earlier than 90 days and no later than 30 days before the distribution is made. However, you can choose to have a distribution made less than 30 days after the explanation is provided as long as the following two requirements are met.

- You must have the opportunity to consider whether or not you want to make a direct rollover for at least 30 days after the explanation is provided.
- The information you receive must clearly state that you have the right to have 30 days to make a decision.

Contact the plan administrator if you have any questions regarding this information.

Choosing the right option. Table 1 may help you decide which distribution option to choose. Carefully compare the effects of each option.

Table 1. Comparison of Payment to You Versus Direct Rollover

Affected item	Result of a payment to you	Result of a direct rollover
Withholding	The payer must withhold 20% of the taxable part.	There is no withholding.
Additional tax	If you are under age 59½, a 10% additional tax may apply to the taxable part (including an amount equal to the tax withheld) that is not rolled over.	There is no 10% additional tax. See <i>Tax on Early Distributions</i> , later.
When to report as income	Any taxable part (including the taxable part of any amount withheld) not rolled over is income to you in the year paid.	Any taxable part is not income to you until later distributed to you from the new plan or IRA.

Special Additional Taxes

To discourage the use of pension funds for purposes other than normal retirement, the law imposes additional taxes on early distributions of those funds and on failures to withdraw the funds timely. Ordinarily, you will not be subject to these taxes if you roll over all early distributions you receive, as explained earlier, and begin drawing out the funds at a normal retirement age, in reasonable amounts over your life expectancy. These special additional taxes are the taxes on:

- Early distributions, and
- Excess accumulation (not receiving minimum distributions).

These taxes are discussed in the following sections.

If you must pay either of these taxes, report them on **Form 5329**. However, you do not have to file Form 5329 if you owe only the tax on early distributions and your Form 1099-R shows a "1" in box 7. Instead, enter 10% of the taxable part of the distribution on line 58 of Form 1040 and write "No" on the dotted line next to line 58.

Even if you do not owe any of these taxes, you may have to complete Form 5329 and attach it to your Form 1040. This applies if you received an early distribution and your Form 1099-R does not show distribution code "2," "3," or "4" in box 7 (or the code shown is incorrect).

Tax on Early Distributions

Most distributions (both periodic and nonperiodic) from qualified retirement plans and nonqualified annuity contracts made to you before you reach age 59½ are subject to an additional tax of 10%. This tax applies to the part of the distribution that you must include in gross income. It does **not** apply to any part of a distribution that is tax free, such as amounts that represent a return of your cost or that were rolled over to another retirement plan. It also does not apply to corrective distributions of excess deferrals, excess contributions, or excess aggregate contributions (discussed earlier at the beginning of *Taxation of Nonperiodic Payments*).

For this purpose, a qualified retirement plan is:

- A qualified employee plan (including a qualified cash or deferred arrangement (CODA) under Internal Revenue Code section 401(k)),
- A qualified employee annuity plan,
- A tax-sheltered annuity plan (403(b) plan), or
- An eligible state or local government section 457 deferred compensation plan (to the extent that any distribution is attributable to amounts the plan received in a direct transfer or rollover from one of the other plans listed here).

5% rate on certain early distributions from deferred annuity contracts. If an early withdrawal from a deferred

annuity is otherwise subject to the 10% additional tax, a 5% rate may apply instead. A 5% rate applies to distributions under a written election providing a specific schedule for the distribution of your interest in the contract if, as of March 1, 1986, you had begun receiving payments under the election. On line 4 of Form 5329, multiply by 5% instead of 10%. Attach an explanation to your return.

Exceptions to tax. Certain early distributions are exempted from the early distribution tax. If the payer knows that an exception applies to your early distribution, distribution code "2," "3," or "4" should be shown in box 7 of your Form 1099-R and you do not have to report the distribution on Form 5329. If an exception applies but distribution code "1" (early distribution, no known exception) is shown in box 7, you must file Form 5329. Enter the taxable amount of the distribution shown in box 2a of your Form 1099-R on line 1 of Form 5329. On line 2, enter the amount that can be excluded and the exception number shown in the Form 5329 instructions.



If distribution code "1" is incorrectly shown on your Form 1099-R for a distribution received when you were age 59½ or older, include that distribution on Form 5329. Enter exception number "11" on line 2.

The early distribution tax does not apply to any distribution that meets one of the following exceptions.

General exceptions. The tax does not apply to distributions that are:

- Made as part of a series of substantially equal periodic payments (made at least annually) for your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your designated beneficiary (if from a qualified retirement plan, the payments must begin after separation from service),
- Made because you are totally and permanently disabled, or
- Made on or after the death of the plan participant or contract holder.

Additional exceptions for qualified retirement plans. The tax does not apply to distributions that are:

- From a qualified retirement plan (other than an IRA) after your separation from service in or after the year you reached age 55,
- From a qualified retirement plan (other than an IRA) to an alternate payee under a qualified domestic relations order,
- From a qualified retirement plan to the extent you have deductible medical expenses (medical expenses that exceed 7.5% of your adjusted gross income), whether or not you itemize your deductions for the year,
- From an employer plan under a written election that provides a specific schedule for distribution of your entire interest if, as of March 1, 1986, you had sepa-

rated from service and had begun receiving payments under the election,

- From an employee stock ownership plan for dividends on employer securities held by the plan, or
- From a qualified retirement plan due to an IRS levy of the plan.

Additional exceptions for nonqualified annuity contracts. The tax does not apply to distributions that are:

- From a deferred annuity contract to the extent allocable to investment in the contract before August 14, 1982,
- From a deferred annuity contract under a qualified personal injury settlement,
- From a deferred annuity contract purchased by your employer upon termination of a qualified employee plan or qualified employee annuity plan and held by your employer until your separation from service, or
- From an immediate annuity contract (a single premium contract providing substantially equal annuity payments that start within one year from the date of purchase and are paid at least annually).

Recapture tax for changes in distribution method under equal payment exception. An early distribution recapture tax may apply if, before you reach age 59½, the distribution method under the equal periodic payment exception changes (for reasons other than your death or disability). The tax applies if the method changes from the method requiring equal payments to a method that would not have qualified for the exception to the tax. The recapture tax applies to the first tax year to which the change applies. The amount of tax is the amount that would have been imposed had the exception not applied, plus interest for the deferral period.

The recapture tax also applies if you do not receive the payments for at least 5 years under a method that qualifies for the exception. It applies even if you modify your method of distribution after you reach age 59½. In that case, the tax applies only to payments distributed before you reach age 59½.

Report the recapture tax and interest on line 4 of Form 5329. Attach an explanation to the form. Do not write the explanation next to the line or enter any amount for the recapture on lines 1 or 3 of the form.

Tax on Excess Accumulation

To make sure that most of your retirement benefits are paid to you during your lifetime, rather than to your beneficiaries after your death, the payments that you receive from qualified retirement plans must begin no later than your **required beginning date** (defined later). The payments each year cannot be less than the **minimum required distribution**.

If the actual distributions to you in any year are less than the minimum required distribution for that year, you are subject to an additional tax. The tax equals 50% of the part

of the required minimum distribution that was not distributed.

For this purpose, a qualified retirement plan includes:

- A qualified employee plan,
- A qualified employee annuity plan,
- An eligible section 457 deferred compensation plan, or
- A tax-sheltered annuity plan (403(b) plan) (for benefits accruing after 1986).

Waiver. The tax may be waived if you establish that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall. If you believe you qualify for this relief, you must file Form 5329, pay the tax, and attach a letter of explanation. If the IRS grants your request, the tax will be refunded.

State insurer delinquency proceedings. You might not receive the minimum distribution because of state insurer delinquency proceedings for an insurance company. If your payments are reduced below the minimum because of these proceedings, you should contact your plan administrator. Under certain conditions, you will not have to pay the 50% excise tax.

Required beginning date. Unless the rule for 5% owners applies, you generally must begin to receive distributions from your qualified retirement plan by April 1 of the year that follows the **later** of:

- The calendar year in which you reach age 70½, or
- The calendar year in which you retire.

However, your plan may require you to begin to receive distributions by April 1 of the year that follows the year in which you reach age 70½, even if you have not retired.

5% owners. If you are a 5% owner of the employer maintaining your qualified retirement plan, you must begin to receive distributions from the plan by April 1 of the year that follows the calendar year in which you reach age 70½. This rule does not apply if your retirement plan is a government or church plan.

You are a 5% owner if, for the plan year ending in the calendar year in which you reach age 70½, you own (or are considered to own under section 318 of the Internal Revenue Code) more than 5% of the outstanding stock (or more than 5% of the total voting power of all stock) of the employer, or more than 5% of the capital or profits interest in the employer.

Age 70½. You reach age 70½ on the date that is 6 calendar months after the date of your 70th birthday. For example, if your 70th birthday was on June 30, 2001, you reached age 70½ on December 30, 2001. If your 70th birthday was on July 1, 2001, you reached age 70½ on January 1, 2002.



In 2002, the IRS announced new rules that simplify the calculation of required distributions. Plans are not required to adopt these new rules until 2003, so the following discussion reflects both the old

and new rules. Check with your plan administrator to see which rules your plan follows.

Required distributions. By the required beginning date, as explained above, you must either:

- Receive your entire interest in the plan (for a tax-sheltered annuity, your entire benefit accruing after 1986), or
- Begin receiving periodic distributions in annual amounts calculated to distribute your entire interest (for a tax-sheltered annuity, your entire benefit accruing after 1986) over your life or life expectancy or over the joint lives or joint life expectancies of you and a designated beneficiary (or over a shorter period).

After the starting year for periodic distributions, you must receive the minimum required distribution for each year by December 31 of that year. (The starting year is the year in which you reach age 70½ or retire, whichever applies in determining your required beginning date.) If no distribution is made in your starting year, the minimum required distributions for 2 years must be made the following year (one by April 1 and one by December 31).

Example. You retired under a qualified employee plan in 2001. You reached age 70½ on August 20, 2002. For 2002 (your starting year), you must receive a minimum amount from your retirement plan by April 1, 2003. You must receive the minimum required distribution for 2003 by December 31, 2003.

Distributions after the employee's death. If the employee was receiving periodic distributions before his or her death, any payments not made as of the time of death must be distributed at least as rapidly as under the distribution method being used at the date of death.

If the employee dies **before the required beginning date**, the entire account must be distributed under one of the following rules.

- **Rule 1.** The distribution must be completed by December 31 of the fifth year following the year of the employee's death.
- **Rule 2.** The distribution must be made in annual amounts over the life or life expectancy of the designated beneficiary.

The terms of the plan determine which of these two rules applies. If the plan permits the employee or the beneficiary to choose the rule that applies, this choice must be made by the earliest date a distribution would be required under either of the rules. Generally, this date is December 31 of the year following the year of the employee's death.

If the employee or the beneficiary did not choose either rule and the plan does not specify the one that applies, distribution generally must be made under rule 2 if the beneficiary is the surviving spouse and under rule 1 if the beneficiary is someone other than the surviving spouse. However, if your plan adopted the new rules proposed by the IRS in 2001 or 2002, distribution must be made under

rule 2 if the employee has a designated beneficiary and under rule 1 if the employee does not have a designated beneficiary.

Distributions under rule 2 generally must begin by December 31 of the year following the year of the employee's death. However, if the surviving spouse is the beneficiary, distributions need not begin until December 31 of the year the employee would have reached age 70½, if later.

If the surviving spouse is the designated beneficiary and distributions are to be made under rule 2, a special rule applies if the spouse dies after the employee but before distributions are required to begin. In this case, distributions may be made to the spouse's beneficiary under either rule 1 or rule 2, as though the beneficiary were the employee's beneficiary and the employee died on the spouse's date of death. However, if the surviving spouse remarries after the employee's death and the new spouse is designated as the spouse's beneficiary, this special rule applicable to surviving spouses does not apply to the new spouse.

Minimum distributions from an annuity plan. Special rules may apply if you receive distributions from your retirement plan in the form of an annuity. Your plan administrator should be able to give you information about these rules.

Minimum distributions from an individual account plan. If there is an **account balance** to be distributed from your plan (not as an annuity), your plan administrator must figure the minimum amount that must be distributed from the plan each year.

Your plan administrator will use rules similar to the rules that are used to figure required distributions from traditional IRAs. The IRA rules are discussed in Publication 590.

Your plan administrator should be able to give you information about how the amount of your required distribution was figured.

What types of installments are allowed? The minimum amount that must be distributed for any year may be made in a series of installments (for example, monthly or quarterly) as long as the total payments for the year made by the date required are not less than the minimum amount required for the year.

More than minimum. Your plan can distribute more in any year than the minimum amount required for that year but, if it does, you will not receive credit for the additional amount in determining the minimum amount required for future years. However, any amount distributed in your starting year will be credited toward the amount required to be distributed by April 1 of the following year.

Combining multiple accounts to satisfy the minimum distribution requirements. Generally, the required minimum distribution must be figured separately for each account. Each qualified employee retirement plan and qualified annuity plan must be considered individually in satisfying its distribution requirements. However, if you have more than one tax-sheltered annuity account, you can total the required distributions and then satisfy the

requirement by taking distributions from any one (or more) of the tax-sheltered annuities.

Survivors and Beneficiaries

Generally, a survivor or beneficiary reports pension or annuity income in the same way the plan participant would have reported it. However, some special rules apply, and they are covered elsewhere in this publication as well as in this section.

Estate tax deduction. You may be entitled to a deduction for estate tax if you receive a joint and survivor annuity that was included in the decedent's estate. You can deduct the part of the total estate tax that was based on the annuity, provided that the decedent died after his or her annuity starting date. (For details, see section 1.691(d)-1 of the regulations.) Deduct it in equal amounts over your remaining life expectancy.

You can take the estate tax deduction as an itemized deduction on Schedule A, Form 1040. This deduction is not subject to the 2%-of-adjusted-gross-income limit on miscellaneous deductions.

Survivors of employees. Distributions the beneficiary of a deceased employee gets may be accrued salary payments, distributions from employee profit-sharing, pension, annuity, or stock bonus plans, or other items. Some of these should be treated separately for tax purposes. The treatment of these distributions depends on what they represent.

Salary or wages paid after the death of the employee are usually the beneficiary's ordinary income. If you are a beneficiary of an employee who was covered by any of the retirement plans mentioned, you can exclude from income nonperiodic distributions received that totally relieve the payer from the obligation to pay an annuity. The amount that you can exclude is equal to the deceased employee's investment in the contract (cost).

If you are entitled to receive a survivor annuity on the death of an employee, you can exclude part of each annuity payment as a tax-free recovery of the employee's investment in the contract. You must figure the tax-free part of each payment using the method that applies as if you were the employee. For more information, see *Taxation of Periodic Payments*, earlier.

Survivors of retirees. Benefits paid to you as a survivor under a joint and survivor annuity must be included in your gross income. Include them in income in the same way the retiree would have included them in gross income. See *Partly Taxable Payments* under *Taxation of Periodic Payments*, earlier.

If the retiree reported the annuity under the Three-Year Rule and had recovered all of his or her cost before death, your survivor payments are fully taxable.

If the retiree was reporting the annuity under the General Rule, you must apply the same exclusion percentage to your initial survivor annuity payment called for in the contract. As discussed in Publication 939, the resulting tax-free amount will then remain fixed for the initial and future payments. Increases in the survivor annuity are fully taxable.

If the retiree was reporting the annuity under the Simplified Method, the part of each payment that is tax free is the same as the tax-free amount figured by the retiree at the annuity starting date. See *Simplified Method* under *Taxation of Periodic Payments*, earlier.

Guaranteed payments. If you receive guaranteed payments as the decedent's beneficiary under a life annuity contract, do not include any amount in your gross income until your distributions plus the tax-free distributions received by the life annuitant equal the cost of the contract. All later distributions are fully taxable. This rule does **not** apply if it is possible for you to collect more than the guaranteed amount. For example, it does not apply to payments under a joint and survivor annuity.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer. With your personal computer and modem, you can access the IRS on the Internet at **www.irs.gov**. While visiting our web site, you can:

- See answers to frequently asked tax questions or request help by e-mail.
- Download forms and publications or search for forms and publications by topic or keyword.
- Order IRS products on-line.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Learn about the benefits of filing electronically (IRS e-file).
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at **ftp.irs.gov**.



TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *Solving problems.* Take advantage of Everyday Tax Solutions service by calling your local IRS office to set up an in-person appointment at your convenience. Check your local directory assistance or **www.irs.gov** for the numbers.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local IRS office to ask tax questions or get help with a tax problem. Now you can set up an appointment by calling your local IRS office number and, at the prompt, leaving a

message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience.



Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**

Western Area Distribution Center
Rancho Cordova, CA 95743-0001

- **Central part of U.S.:**

Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903

- **Eastern part of U.S. and foreign addresses:**

Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074



CD-ROM for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.
- Popular tax forms that may be filled in electronically, printed out for submission, and saved for record-keeping.

- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at **<http://www.irs.gov/cdorders>**. The first release is available in early January and the final release is available in late February.



CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide*, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in March. You can get a free copy by calling **1-800-829-3676** or by visiting the website at **www.irs.gov/smallbiz**.

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



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

Table 1 for Line 3 Above

AND your annuity starting date was—

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

Table 2 for Line 3 Above

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



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