

Taxation of Pension Amounts

Pension payments from tax qualified retirement plans are generally taxed as ordinary income. However, the portion of the pension payments derived from employee contributions that have already been taxed can be excluded. The amount of each monthly pension check that can be excluded from taxation is determined by dividing their retiree's *investment in contract* by the *expected number of monthly payments*, as set forth by the Internal Revenue Service.

$$\text{Amount excludable from tax} = \frac{\text{Retiree's investment in Contract}}{\text{Expected number of monthly payments}}$$

The *investment in contract* is the retiree's after tax contributions, excluding interest and contributions "picked-up" by the employer under Section 414(h) of the Internal Revenue Code.

The *expected number of monthly payments* is set forth in the Internal Revenue Code and depends on the age of the retiree at retirement, or the combined ages of the retiree and beneficiary if the pension is payable over more than one lifetime.

The number of monthly payments is defined in the Internal Revenue Code to be the following:

| Pension Payable for a Single Life | | | Pension Payable for More than One Life | |
|--|------------------------------------|--|---|------------------------------------|
| Age of Primary Recipient | Expected Number of Payments | | Combined Ages of Retiree and Beneficiary | Expected Number of Payments |
| 55 and under | 360 | | 110 and under | 410 |
| 56-60 | 310 | | 111-120 | 360 |
| 61-65 | 260 | | 121-130 | 310 |
| 66-70 | 210 | | 131-140 | 260 |
| 71 and over | 160 | | 141 and over | 210 |

If the pension is based on a fixed number of payments rather than the lifetime of one or more recipients, the fixed number is used as the expected number of payments.

The table above is applicable for retirements on or after January 1, 1998.

Example

Assume a person retires at age 50 with a monthly pension of \$3,000. The retiree's spouse is age 48. The pension will be payable for the lifetime of the retiree. If the retiree dies before the eligible surviving spouse, 80% of the monthly pension, or \$2,400, will continue to the surviving spouse for the surviving spouse's lifetime.

At retirement, the retiree's accumulated contributions totaled \$60,000. Of that amount \$20,000 was contributed by the retiree post-tax, \$25,000 was "picked-up" by the employer pre-tax, and \$15,000 was interest that had not been taxed. The retiree's "investment in the contract" would therefore be \$20,000:

| | |
|---------------------------------------|----------|
| Total Accumulated Contributions | \$60,000 |
| Less: Picked-Up Contributions Pre-Tax | \$25,000 |
| Less: Interest | \$15,000 |
| Retiree's Investment in Contract | \$20,000 |

The combined ages of the retiree and beneficiary total 98 (50 plus 48). The expected number of payments from the table is therefore 410.

The amount of each monthly pension payment that would be excluded from tax would be \$20,000 divided by 410, or \$48.78. This amount *does not change* throughout the 410 month period.

The initial taxable portion of each monthly pension payment would be \$3,000 minus \$48.78, or \$2,951.22. This taxable amount of \$2,951.22 will change if the pension changes, as the result of cost-of-living adjustments or the death of the retiree, for example.

After 410 months, the total monthly pension is taxable.

If both the retiree and beneficiary die before 410 monthly pension payments are made, a deduction is allowed in the last income tax return in the amount of the unrecovered investment in contract.

This method is not allowed if the age of the retiree at retirement is older than 75 and there are more than 5 years of pension payments guaranteed.

10/21/02

EXAMPLE

EXCLUSION RATIO

SAFE HARBOR METHOD

| | |
|--|----------------------|
| 1. DATE OF RETIREMENT | <u>09/01/2005</u> |
| 2. MONTHLY BENEFIT FOR LIFE (may be a single life or joint life benefit) | <u>\$ 3,000.00</u> |
| 3. MEMBER ACCUMULATED CONTRIBUTIONS | |
| a. TOTAL CONTRIBUTIONS | <u>\$ 100,000.00</u> |
| b. INTEREST CREDITS AND CONTRIBUTIONS "PICKED UP" UNDER SECTION 414(h) | <u>\$ 12,000.00</u> |
| c. INVESTMENT IN CONTRACT: (A) - (B) | <u>\$ 88,000.00</u> |
| 4. AGE AT RETIREMENT | <u>51</u> |
| 5. EXPECTED NUMBER OF PAYMENTS FROM TABLE | <u>360</u> |
| 6. TAX-FREE PORTION OF MONTHLY BENEFIT (ITEM 3c/ITEM 5) | <u>\$ 244.44</u> |
| 7. INITIAL TAXABLE PORTION OF BENEFIT (ITEM 2 - ITEM 6) | <u>\$ 2,755.56</u> |
| 8. DATE WHEN BENEFIT BECOMES FULLY TAXABLE (ITEM 5) MONTHS AFTER DATE OF RETIREMENT | <u>09/01/2035</u> |

EXAMPLE