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TO: StanCERA Retirees  
FROM: Tom Watson, Retirement Administrator  
SUBJECT: Taxation of Retirement Benefits  
DATE: January 17, 2006

Over the past two decades, federal Internal Revenue Service (IRS) laws have changed related to the taxation of retirement benefits. California State income tax law has also changed. StanCERA staff is certainly not tax experts and cannot provide tax advice. However, we determined this year to provide retirees who are receiving a pension and do not take a refund with general information that we thought would be helpful in understanding your taxes. Please consult with a professional tax advisor for help with your individual questions and for filing your tax returns.

Generally, the full amount of your pension is taxable. However, if a retiree made contributions to StanCERA from already taxed funds, the retiree is entitled to reduce the taxable amount of his or her retirement benefits in accordance with detailed rules set forth by the IRS. For federal income tax, retirees generally fall into one of three categories. If the original retirement date of a StanCERA retiree was before July 2, 1986, benefits paid now are most likely 100% taxable because the retiree most likely has already reduced the taxable amount of his or her benefits received by the entire amount of after-tax contributions. If the original retirement date of a retiree is from July 2, 1986 through November 18, 1996, the retiree recovers the already taxed contributions spread out over a fixed number of years according to the IRS chart based on the retiree's age at retirement. Each year, the portion recovered reduces the taxable amount of your pension. If the original retirement date of a retiree is on or after November 19, 1996, the retiree recovers already taxed contributions over a fixed number of years in accordance with revised IRS charts based on the age of the retiree and beneficiaries. For those retirees who continue to receive some recovery of their already taxed contributions, the taxable amount in box 2a of the 1099-R reflects this reduction to arrive at the net taxable amount of your benefits. The amount in box 2a is the amount to report to the IRS.

An exception to the above taxation rules is the retiree who receives a service-connected disability retirement. If the monthly allowance is no more than one-half of the retiree's final average salary ("FAS") at the point of retirement, then generally this amount (with any associated cost of living adjustment) is excludable from taxable income. As described in the enclosed memorandum, there are different rules if the retiree receives more than one-half of FAS or if the disability is based on a statutory "presumption".

You will be receiving your annual 1099-R form for the year 2005 benefits paid in the next week. Box 1 contains the total gross amount of benefits paid out that we must report to the

IRS and box 2a shows the net taxable amount (after deducting any recovery of the already taxed member contributions that you made while employed or the statutory amount related to a service connected disability retirement).

For this year only, we have included a copy of a brief summary of retirement benefit taxation, a worksheet for your particular status (if applicable) and a copy of information that shows your already taxed contributions (to help you verify that the box 2a taxable benefit amount is calculated correctly). PLEASE KEEP THESE DOCUMENTS ON HAND FOR THIS YEAR AND FUTURE YEARS' INCOME TAX PREPARATION.

As always, if you do need any further information from StanCERA staff that we can supply (remember that we are NOT tax experts and cannot provide you with tax advice!), please contact us!

# **Taxation of Your Retirement Benefit**

**This is a general summary of how StanCERA withholds from retirement payments and reports such payments and withholding to the Internal Revenue Service (“IRS”) and California Franchise Tax Board (“FTB”). The general provisions in this summary may not apply to your benefits. You should consult with an independent tax professional to ensure that you are properly filing your tax returns and paying the correct amount of federal and state taxes.**

## **Retiree Payroll Federal and State Income Tax Withholding Information**

All Stanislaus County Employees' Retirement Association (StanCERA) retirees who receive a pension and do not take a refund are required to select one of three tax withholding options:

- to have no federal and/or state income taxes withheld;
- to have a specific dollar amount withheld for federal and/or state income taxes;
- to have federal and/or state income taxes withheld according to tax tables based on marital status and number of exemptions.

For those who elect to have their withholding based on tax tables, taxes will not be withheld unless your gross monthly retirement allowance exceeds the minimum amount listed on the tax table for your filing status. If you do not choose a filing status and exemption, StanCERA will withhold state and federal taxes based upon a filing status of married with three exemptions.

You may be subject to penalties assessed by the IRS and FTB if you do not have a sufficient amount of tax withheld and fail to pay the correct amount of estimated taxes during the year that you receive income.

## **California State Tax Information for Non-Residents**

If you live outside the State of California, no California state taxes will be withheld unless you elect withholding. StanCERA is still required to report the benefits paid to the California Franchise Tax Board.

## **1099-R Tax Statement**

Each January, StanCERA will provide you with a 1099-R form that contains information on the benefits paid to you by StanCERA in the prior calendar year. Box 1 of the 1099-R, labeled "Gross Distribution," contains the total amount of the retirement benefits paid in the prior year (including any Health Insurance Allowance). There are special rules for service connected disability benefits, described in the section below. Box 2a, labeled "Taxable Amount" contains the amount of the benefit that is taxable (including the Health Insurance Allowance).

## **Service-Connected Disability Retirement**

The Internal Revenue Code provides special tax treatment if you retire due to a service-connected disability. Service-connected disability benefits from StanCERA that are not calculated based upon your age, service or contributions generally may be excluded from taxation. If your service connected disability pension is no more than 1/2 of your final average salary (“FAS”) as determined by StanCERA, the entire amount is generally tax

free because it is in the nature of workers compensation. If your service connected disability pension is more than 1/2 of your FAS, then generally the part that equals 1/2 of FAS is tax free and the remainder is taxable. However, if you retire on a disability under a “statutory presumption” that it is service connected (e.g., for heart trouble or cancer), generally the IRS and FTB will not treat your pension as tax free.

In addition, if all or part of your pension is tax free because it is service connected, then generally any related COLA is tax free. The COLA will be prorated so that, for example, if 3/4s of your pension is tax free, then 3/4s of the COLA will be tax free.

Because the Health Insurance Allowance is based on your number of years of service, it is taxable even if you receive a service connected disability pension.

If you receive any taxable amount from StanCERA, the entire benefit paid to you will be reported in Box 1 of the 1099-R as Gross Distribution. The taxable amount reported in Box 2a will be reduced by any tax free service connected disability and by a portion of your after-tax contributions calculated using the rules for regular retirement payments as set out below.

Please note that if you retire with a service-connected disability and elect to have taxes withheld from your monthly benefit using the tax tables, the amount withheld from your monthly check will be based on the total monthly allowance that you receive. This may result in excess withholding.

### **Calculation of the Taxable Amount of Your Benefit**

Generally, the full amount of your pension is taxable except as described above for service connected disability benefits. Also, the Health Insurance Allowance is taxable. However, if you contributed to StanCERA from after-tax funds, then you can recover these amounts tax free. The amount of your after-tax contributions that you can recover tax free each year is reported on Box 5 of your Form 1099-R. The rules on recovery are different depending on when you retired.

#### **If you retired before July 2, 1986...**

...the "Three Year Rule" was the method used to determine the taxability of your retirement benefit (so long as your total after-tax contributions did not exceed your total pension payments for the first 36 months of distribution). This rule allowed you to take up to 36 months of your initial retirement income tax free in order to recover your previously taxed contributions to the plan. Your retirement benefit is most likely fully taxable now.

#### **If you retired between July 2, 1986 through November 18, 1996...**

... StanCERA uses the IRS safe harbor method under which you recover your already taxed contributions over a fixed number of years that were calculated based upon your age at retirement. (See 1099-R Retiree Worksheet 1 for the calculation format.) You should have a letter that was sent in the year of your retirement with the already taxed contributions amount typed on it. Contact StanCERA staff if you need this information.

#### **If you retired on or after November 19, 1996...**

...StanCERA uses the IRS-required method under which you recover your already taxed contributions over a fixed number of years that are calculated based upon either your age at retirement or the combined ages of you and your youngest beneficiary.

In order to calculate an estimate of the taxable portion of your retirement benefit under this method you need to know the amount of after-tax contributions you made to StanCERA during your employment. This amount is listed on the Retirement Allowance Program summary provided to you at the time of your retirement, or can be provided to you by contacting StanCERA staff.

If your retirement allowance will NOT continue to anyone upon your death, you can use the 1099-R Retiree Worksheet 3 to calculate your StanCERA retirement taxable income.

If your retirement allowance will continue on to your beneficiary upon your death (even at a reduced rate), the 1099-R Retiree Worksheet that you use to calculate your StanCERA retirement taxable income will depend upon your retirement date. If you retired on or after November 19, 1996, and before January 1, 1998, you can use the 1099-R Retiree Worksheet 3 to calculate your StanCERA retirement taxable income. If you retire on or after January 1, 1998, you can use the 1099-R Retiree Worksheet 2 to calculate your StanCERA retirement taxable income.

### **ADDITIONAL INFORMATION**

StanCERA's staff cannot provide tax advice so cannot answer your personal tax questions. If you have questions regarding federal income taxes please contact the Internal Revenue Service (800) 829-1040, or state income taxes contact the State Franchise Tax Board (800) 852-5711, or consult with your personal tax advisor. You may also wish to obtain a copy of Internal Revenue Service Publication 575, "Pension and Annuity Income", or visit the web site at <http://www.irs.ustreas.gov/> for more detailed information on the federal taxation of your retirement benefit. For more information on California taxation of your retirement benefit, you may wish to obtain a copy of State of California Franchise Tax Board Publication 1005 "Pension and Annuity Guidelines."

# 1099-R Retiree Worksheet 1

Retirement Dates July 2, 1986 to November 18, 1996

If you retired between July 2, 1986 and November 18, 1996, the Worksheet below can be used to make the computation of the taxable amount of your retirement benefits.

1. Total Pension Received (1099-R Box 1): \_\_\_\_\_
2. After-tax contributions made during your employment: \_\_\_\_\_

<u>Your age at Retirement</u>	<u>Number of Payments</u>
55 and under	300
56 - 60	260
61 - 65	240
66 - 70	170
71 and over	120

3. Divide the amount on line 2 by the number of payments based on your age at retirement: \_\_\_\_\_
4. Multiply line 3 above by the number of months you received retirement benefits this year (up to 12):  
(This is the tax-exempt or non-taxable amount) \_\_\_\_\_
5. Taxable amount for the year equals line 1 minus line 4:  
(This amount should closely approximate your 1099-R Box 2a amount) \_\_\_\_\_

# 1099-R Retiree Worksheet 2

Retirement Date on or After November 19, 1996  
(Retiree with a Beneficiary Continuance)

If you retired on or after November 19, 1996 and have a beneficiary who will receive a monthly continuance after your death, the Worksheet below can be used to make the computation of the taxable amount of your retirement benefits.

1. Total Pension Received (1099-R Box 1): \_\_\_\_\_

2. After-tax contributions made during your employment: \_\_\_\_\_

<u>Your Age PLUS the Age of Your Beneficiary AT RETIREMENT</u>	<u>Number of Payments</u>
110 and under	410
111 - 120	360
121 - 130	310
131 - 140	260
141 and over	210

3. Divide the amount on line 2 by the number of payments based on your combined ages at retirement: \_\_\_\_\_

4. Multiply line 3 above by the number of months you received retirement benefits this year (up to 12):  
(This is the tax-exempt or non-taxable amount) \_\_\_\_\_

5. Taxable amount for the year equals line 1 minus line 4:  
(This amount should closely approximate your 1099-R Box 2a amount) \_\_\_\_\_

# 1099-R Retiree Worksheet 3

Retirement Date on or After November 19, 1996  
(Retiree ONLY)

If you retired on or after November 19, 1996 and DO NOT have a beneficiary who will receive a monthly continuance after your death, the Worksheet below can be used to make the computation of the taxable amount of your retirement benefits.

1. Total Pension Received (1099-R Box 1): \_\_\_\_\_

2. After-tax contributions made during your employment: \_\_\_\_\_

<u>Your age at Retirement</u>	<u>Number of Payments</u>
55 and under	360
56 - 60	310
61 - 65	260
66 - 70	210
71 and over	160

3. Divide the amount on line 2 by the number of payments based on your age at retirement: \_\_\_\_\_

4. Multiply line 3 above by the number of months you received retirement benefits this year (up to 12):  
(This is the tax-exempt or non-taxable amount) \_\_\_\_\_

5. Taxable amount for the year equals line 1 minus line 4:  
(This amount should closely approximate your 1099-R Box 2a amount) \_\_\_\_\_