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General Government Division

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May 3, 1999

The Honorable Amo Houghton
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Subject: Determining the Taxable Portion of Federal Pension Distributions

Dear Mr. Chairman:

This letter responds to your request that we inform you of the results of a review we undertook to determine (1) what reasons, if any, exist for the Office of Personnel Management (OPM) to report the taxable portion of annuity benefits for newly retired federal employees on the Form CSA 1099R (Statement of Annuity Paid) and (2) the feasibility of OPM's doing so.[1] Part of a federal retiree's gross annuity is a tax-free recovery of the retiree's contribution to the retirement system. Currently, OPM reports the gross annuity on Form CSA 1099R, and the retiree has to calculate the taxable portion of the annuity. Under what is called the Simplified Method, the taxable portion is determined using a calculation that takes into account the age of the retiree,[2] the month and year the person retired, and the amount of the retiree's contribution to the retirement system.

Results in Brief

There are three reasons for OPM to report on Form CSA 1099R the taxable portion of the annuity for newly retired federal employees. First, the task of calculating this portion can be burdensome from the retirees' perspective. Second, the complexity of the requirement could result in retirees' miscalculating the taxable portion of their annuity for income tax purposes. Finally, reporting the taxable portion of the annuity on Form CSA 1099R would allow the Internal Revenue Service (IRS) to use it for computer matching purposes. Computer matching of information and tax returns is one way that IRS verifies a taxpayer's income to determine the proper tax owed.

[1] OPM administers two retirement programs—Civil Service Retirement System (CSRS) and Federal Employees' Retirement System (FERS)—which together covered about 93 percent of the federal civilian workforce in 1998. CSRS and FERS require federal employees to make contributions to their retirement plans. These contributions are taxable in the year they are made. After retirement, the portion of the annuity disbursement refunding the employee's contribution is not taxable. The remainder of the federal employee's retirement benefit is subject to income tax.

[2] The Taxpayer Relief Act of 1997 required a cost recovery factor that takes into consideration the age of the retiree's spouse if the retiree' s annuity provides survivor benefits. The change was effective for retirees whose annuity starting date was after 1997.

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According to OPM officials, it would be feasible for OPM to report the taxable portion on Form CSA 1099R for federal employees with annuities starting after November 18, 1996, when the Simplified Method became the only method allowed.[3] Before that date, retirees could use either a Simplified Method or the General Rule method,[4] and OPM would not know which method the retiree preferred. OPM has the necessary data, which are computerized, to make the Simplified Method calculation. The officials we spoke with said that a calculation formula could easily be programmed to determine the tax-free amount and subtract it from the retiree's gross annuity amount. They also said the costs of doing so would not be large. OPM expects to report taxable amounts on tax year 2000 Forms CSA 1099R in January 2001 for employees who retired after November 18, 1996. The officials said that OPM has taken other actions to help retirees calculate the taxable amount.

Reasons to Report the Taxable Portion on the Form CSA 1099R

The first reason why OPM may want to report the taxable portion of an annuity is that the task of calculating it can be burdensome for retirees. They must maintain records on the amount of their contributions and the amount recovered each year, as well as determine the rate at which these contributions are to be recovered and whether a portion of the distribution is excludable from income. OPM officials stated that OPM is committed to providing fast, friendly, accurate, and cost-effective services to federal retirees and providing the taxable amount on the Form CSA 1099R would contribute to these goals and would reduce retirees' tax preparation burden.

Second, according to IRS officials, retirees may miscalculate the taxable portion of their annuity and incorrectly report their pension income on their tax returns. For retirees who find it too confusing, IRS will figure the taxable portion of their pension distribution for an $80 fee for the 1998 tax year. However, an IRS official said no one has requested IRS to perform the calculation for the Simplified Method and that if such a request were made, IRS would likely waive the fee.

Third, having OPM report the taxable amount on Form CSA 1099R would allow IRS to verify that taxpayers properly reported their federal annuity. IRS matches through the computer information from third parties, such as employers and financial institutions, with information on individual tax returns. When matching reveals an income difference between the data on the tax return and information returns, IRS contacts the taxpayer to clear up the discrepancy.

IRS considers computer document matching to be its primary enforcement tool for dealing with individual taxpayers. In 1997, IRS' document matching program identified about 1.2

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[3]The Simplified Method is generally effective for annuity starting dates after November 18, 1996. However, if an annuitant with an annuity starting date after November 18, 1996, and before January 1, 1997, failed to use the Simplified Method, IRS would allow use of the methods in use before 1996 for returns filed in 1996 and 1997. The annuitant must use a transition rule for annuity payments made after January 1, 1998.

[4]The General Rule uses the ratio of the retiree's cost in the annuity contract to the total amount the retiree and survivors can expect to receive under the contract, based on actuarial tables. This ratio is multiplied by the annuity payments received to determine the tax-free part of each payment.

million income reporting deficiencies associated with Forms 1099R. However, because the Form CSA 1099R information return issued by OPM does not contain the taxable annuity amount, IRS is unable to match federal retirees' tax returns for misreported pension income. Reporting the taxable annuity amount on the Forms CSA 1099R and providing IRS with that information would allow IRS to verify federal retirees' annuity income.

Feasibility of OPM's Calculating the Taxable Portion of the Pension Disbursement

OPM officials said that it would be feasible for OPM to report the taxable portion for recent retirees on Form CSA 1099R. Before 1986, OPM reported the taxable amount on the form that preceded the Form CSA 1099R because retirees were generally required to use the Three-Year Rule. Under this rule, all annuity payments were nontaxable until all of the retiree's contributions were recovered, after which the annuity was fully taxable. According to OPM officials, since tax year 1985, OPM has not reported the taxable amount on the Form CSA 1099R because it did not know whether retirees used the Simplified Method or the General Rule to calculate the taxable portion of the annuity disbursement. Federal retirees with annuities starting after July 1, 1986, could use either the Simplified Method or the General Rule to calculate the taxable portion of their annuity.

However, the Small Business Job Protection Act of 1996 required retirees with annuities starting after November 18, 1996, to use the Simplified Method only. OPM maintains in its computer database the age, retirement date, and contribution data needed to calculate the taxable portion of the annuity under the Simplified Method. OPM officials stated that calculating the taxable annuity amount and adding it to the Form CSA 1099R would not be technically difficult or costly.

According to OPM officials, a formula for making the calculation could easily be programmed into the computer that would annualize the monthly tax-free amount and subtract this from the retiree's gross annuity amount. OPM officials said that reporting the taxable amount on Form CSA 1099R had not yet been under active consideration, in part because ensuring that OPM's computer systems are Year 2000 compliant has preempted other considerations. They said that given these competing priorities, the taxable amount might be added to the Form CSA 1099R for tax year 2000 reporting for federal employees who retired after November 18, 1996.

OPM officials told us that OPM has taken other actions to make it easier for retirees to report the taxable portion of their annuities. For example, OPM plans to calculate the tax-free amount of the annuity for each retiring employee and print this amount in a personalized booklet it will provide to each employee shortly after his or her retirement. This offers retirees a way to check their yearly taxable calculation because, although the taxable portion of an annuity changes from year to year with cost-of-living adjustments, the tax-free amount does not. Thus, subtracting the tax-free amount from the annuity amount for a given tax year would be one way to determine the taxable portion of that annuity. Also, beginning in January

1999, OPM has posted information on the rule changes related to these calculations on its Web site.

Agency Comments

We requested comments on a draft of this letter from the Director of the Office of Personnel Management and the Commissioner of Internal Revenue. On April 20, 1999, we obtained written comments from the Director of the Office of Personnel Management. (See enclosure.) OPM agreed that reporting the taxable amount on the Form CSA 1099R would be a valuable service to its customers. OPM expects to report taxable amounts to retirees on the earning statements they receive in January 2001. Further, OPM plans to add an on-line calculator to its Web site that retirees can use to compute their monthly and annual tax-free benefits. On April 9, 1999, we obtained comments from the Chief Operations Officer, Internal Revenue Service. IRS had no concerns or comments to make with respect to any issue involving IRS.

Scope and Methodology

To accomplish each objective, we interviewed knowledgeable officials at OPM headquarters, and IRS' National Office. We collected and reviewed relevant OPM and IRS documents and publications pertaining to retirement procedures and the retirement annuity calculation. We collected data on how OPM computes the annuity amount and prepares the required supporting tax documentation. We collected data relevant to IRS' use of information returns to detect noncompliance with the tax laws. We did our work from January to March 1999 in accordance with generally accepted government auditing standards.

We are sending copies of this letter Representative William J. Coyne, Ranking Minority Member of your Subcommittee; Representative Bill Archer, Chairman, and Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means; and Senator William V. Roth, Jr., Chairman, and Senator Daniel Patrick Moynihan, Ranking Minority Member, Senate Finance Committee. We are also sending copies to the Honorable Janice R. Lachance, Director, Office of Personnel Management; the Honorable Jacob J. Lew, Director, Office of Management and Budget; the Honorable Robert E. Rubin, Secretary of Treasury; and the Honorable Charles O. Rossotti, Commissioner of Internal Revenue. We will make copies available to others upon request.

Major contributors to this report were Elwood D. White, Evaluator-in-Charge, and Ralph T. Block, Assistant Director. If you have any questions about the information contained in the letter, please call Ms. Wrightson at (202) 512-9110 or Mr. Brostek at (202) 512-8676.

Sincerely yours,

Margaret T. Wrightson

Margaret T. Wrightson
Associate Director, Tax Policy and
Administration Issues

Michael Brostek

Michael Brostek
Associate Director, Federal Management
and Workforce Issues

Comments From the Office of Personnel Management

UNITED STATES
OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, DC 20415-0001

OFFICE OF THE DIRECTOR

APR 20 1999

Ms. Margaret T. Wrightson
Associate Director, Tax Policy and
Administration Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Wrightson:

Thank you for the opportunity to review your proposed report on Determining the Taxable Portion of Federal Pension Distributions.

Your draft accurately describes our commitment to report the taxable portion of retirement benefits on the annual earnings statements we send to Federal retirees. I am pleased that we will be able to offer this valuable service to our customers. Our goal is to begin reporting taxable amounts on statements for benefits paid next year. That is, we expect to report taxable amounts to retirees on the earnings statements they receive in January 2001.

As you know, we plan to report the monthly tax-free amount to new retirees in the personalized booklet to be sent when their benefits are established. In addition to the information on this subject posted on our web site, within the next several weeks we will also have available an online calculator that customers can use to compute their monthly and annual tax-free benefits. With these several efforts, we believe there will be little room for confusion for our customers on this otherwise complicated subject.

If we can be of further assistance, please do not hesitate to contact us.

Sincerely,

Janice R. Lachance

Janice R. Lachance
Director

CON 131-64-4
September 1993

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