Ten-year forward averaging

Wealth Management

If you were born before 1936 and are receiving a lump-sum distribution from your employer's qualified retirement plan, you have a special option available that may save you some tax dollars. It is called 10-year forward averaging.

What is 10-year forward averaging?

Ten-year forward averaging is a special tax computation available only to individuals born before 1936 that are taking a lump-sum distribution from their qualified retirement plan. Ten-year forward averaging allows you to figure the tax on your lump-sum distribution by applying 1986 tax rates to one-tenth of the amount of your distribution, then multiplying the resulting tax amount by 10. This tax is payable for the year in which you receive the lump-sum distribution.

Why might I want to do this?

The potential advantage of 10-year forward averaging is twofold. First, you treat the lump-sum distribution as a completely separate tax calculation. In other words, even if you have substantial employment or investment income in the year in which you receive the distribution, you do not add the distribution amount to the other income to calculate your taxes. This may keep income from both sources in a lower marginal tax bracket. For example, if you had $50,000 income from wages and received a $150,000 lump-sum distribution, adding them together would cause your wage income to be taxed at a higher bracket, the $150,000 – $200,000 bracket.

The second potential advantage is that the tax on your lump-sum distribution is 10 times the tax on one-tenth the amount. This will certainly keep you in a lower tax bracket. For example, if your lump-sum distribution is $150,000, you would calculate the tax on $15,000 using 1986 tax rates and then multiply the result by 10. The marginal tax rate on $15,000 in 1986 was 23%, so, with 10-year averaging, you would have all of your distribution taxed at 23% or less.

What qualifies as a lump sum distribution?

In addition to the distribution recipient being born before 1936, the distribution must meet the IRS definition of lump-sum distribution to be eligible for the forward-averaging. The following must be true:

- The entire balance from the plan (and all like type of plans offered by the employer) must be distributed to the participant within one calendar year
- The reason for the distribution must be separation from service, attainment of age 59½, or the death of the participant
- The participant must have participated in the plan for at least five tax years prior to the year of the distribution (unless the reason for the distribution is the death of the participant)

Are there any disadvantages to using 10-year forward averaging?

Because the calculation for 10-year averaging uses 1986 tax rates and the top tax rate in 1986 was 50%, you may not gain an advantage from this treatment if your distribution amount is large. Ask your tax advisor to make the calculation for you so you can compare.

The other disadvantage to 10-year forward averaging is that you forego future tax deferral. For example, if you roll your lump-sum distribution to an IRA, you will continue to defer taxes on the distribution and its growth into the future. Tax deferral can boost your overall investment return over a long time period.

How RBC Wealth Management can help you

Your qualified employer-sponsored retirement plan may be the largest piece of your retirement income. How you handle this money at retirement will affect your financial well being, both now and in the future. Your RBC Wealth Management® financial advisor can work closely with you and your tax advisor to help you determine if a lump-sum distribution from your qualified retirement plan and the 10-year forward averaging tax computation are right for you.

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