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Tax Deferring Optional Service Purchases Fact Sheet

Members of the State Employees' Retirement System (SERS) have always been able to purchase optional service credit available to them on a post-tax basis, but now they can tax-defer these purchases through payroll deduction or a rollover. This allows members to delay taxation until retirement.

The following examples illustrate how you can save money by tax-deferring payments for optional service credit purchases.

EXAMPLE A:
Employee A has a gross income of $39,384 and is in the 25% tax bracket. He would like to purchase military credit on an installment plan over two years. The total cost to purchase this military credit is $9,600. If he decides to purchase his military time on a pre-tax basis, his tax-deferred contribution would be $400 per month, or $200 per pay period. Because he is purchasing pre-tax, his paycheck would only be reduced by $150 per pay period instead of $200.

EXAMPLE B:
Employee B also wants to purchase two years of military credit. He earns the same as Employee A, and also agrees to the irrevocable pre-tax deferral to purchase his military credit. After paying $7,200 of the total amount over 18 months, Employee B terminates employment.

He would then have the option of paying the remaining balance on a post-tax basis within 30 days, make a trustee-to-trustee transfer of the remaining balance or take a refund of the $7,200 already paid with taxes withheld and reported as income in that calendar year.

Optional Service Purchases

Tier 1 members may purchase their qualifying periods, if applicable (the first six or twelve months of service when a member did not contribute to SERS). All members may purchase refunded service, short periods of employment, military service and service for leaves of absence after Jan. 1, 1982. Purchasing service credit usually requires the payment of contributions, plus interest.

Payroll Deductions

Active SERS members have the option of purchasing service credit through payroll deductions on a pre- or post-tax basis. Members may also make payments directly to SERS on a post-tax basis.

The pre-tax withholding is made through an irrevocable payroll agreement with specific conditions for the total service credit amount. Once all payments have been received, the member's account is credited for the service purchased. This credit is reflected in future benefit statements. If this method is selected, the payroll withholding cannot be terminated or changed for any reason other than termination of employment, disability or death. If the member dies, a partial service credit may be granted based on contributions and interest paid before the member's date of death.

Payment Interruptions

If a member retires, resigns or is absent from payroll due to a layoff, strike or disability, the member has the option to do one of the following:

1. Make an after-tax lump-sum payment for the remaining balance due;
2. Make a trustee-to-trustee transfer to SERS from an eligible deferred compensation, 403(b) or IRA account for the remaining balance due; or
3. Take a refund of the amount already paid, less applicable taxes, to be reported as income within that calendar year.

Following the notification of the balance due from SERS, the member has 30 days to make the after-tax payment or arrange the trustee-to-trustee transfer.

Lump-Sum Salary Payments

Some employees will receive a lump-sum payment at retirement for unused sick days earned between January 1, 1984 and December 31, 1997, as well as unused vacation and personal time. This lump-sum payment can also be used to purchase optional service credit on a tax-deferred basis. The lump-sum election must be completed before the member leaves state service.

If a member's lump sum payment at resignation is not enough to pay for the total amount of credit purchased, the remaining balance is due by either one of these options:

1. On a post-tax basis 30 days after notification by SERS;
2. By a trustee-to-trustee transfer;
3. With an eligible rollover.

Rollovers

You may roll money over from an eligible pension plan or individual retirement account (IRA) to purchase optional service credit.

Members may also transfer money while still employed from their deferred compensation account (457) or tax-sheltered annuity (403(b)) to purchase service credit or repay a refund.

How Tax Deferment Works

Tax-deferring optional service purchases allows you to postpone paying taxes on your service purchase until you begin receiving a pension — when you are usually in a lower tax bracket.

The deferred compensation plan is another example of tax savings, since all contributions are also tax-deferred until you begin drawing your retirement funds from your deferred compensation account.