

Important Information About Tax-Deferred Salary Reduction to Purchase Service Credit

A private letter ruling from the Internal Revenue Service (IRS) provides for VRS members to purchase prior service credit on a tax-deferred basis through salary reduction provided the employer has adopted the required resolution. You must purchase the service through salary reduction and sign an *irrevocable* Agreement for Salary Reduction to Purchase Service Credit (VRS-26E) providing the terms of the purchase before reductions begin. Based on the IRS ruling, the agreement is a binding contract and can only be broken due to an unforeseeable emergency, which is defined in Internal Revenue Code Section 457 and Treasury Regulation 1.457-6(c)(2)(i) as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse, or the participant's or beneficiary's dependent (as defined in section 152(a)); loss of the participant's or beneficiary's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by homeowner's insurance, e.g., as a result of a natural disaster); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. **If you elect this method for the purchase of prior service credit and later terminate employment or retire before completing the agreement, you *cannot* purchase the remaining months of prior service credit through a lump sum payment.**

What is the advantage to purchasing prior service credit on a tax-deferred basis?

Purchasing prior service credit on a tax-deferred basis reduces the amount of your taxable income that is subject to income taxes. Because the amount of your salary reduction to purchase prior service credit is treated as an employer contribution for purposes of determining federal and state income tax withholding, it is subtracted from your taxable income before federal and state income taxes are applied. This allows you to achieve current-year tax savings while accumulating service credit towards retirement.

How do I purchase service on a tax-deferred basis?

If your employer has authorized your eligibility to purchase service and provides the tax-deferred option to purchase service, you must read and sign this binding, *irrevocable* Agreement for Salary Reduction (VRS-26E). This document serves as a contract between you and VRS. You provide the number of months you wish to purchase on a tax-deferred basis through salary reduction on the agreement. If you cannot fulfill the terms of this contract, you *cannot* purchase the remaining months in a lump-sum payment unless a financial hardship is documented.

Am I required to purchase all eligible service?

You may contract for less than the full amount of the eligible service credit. After completing that contract, you can execute a new contract for an additional portion of service credit. VRS strongly suggests you take into consideration the possibilities of an early retirement or changes in employment status before providing the number of months to be purchased on a tax-deferred basis. For example, you may be eligible to purchase 36 months of service but want to retire a year from now. In this case, you could purchase 12 months on a tax-deferred basis and pay for the remaining months by lump-sum purchase. **For Plan 2 Members:** If the rate for purchasing the service varies based on the type of service you are purchasing, a new contract is required each time the rate changes.

Are there other potential tax implications to a tax-deferred purchase?

Various sections of the Internal Revenue Code place limits on the amount of contributions an employee may make to a deferred compensation plan under IRC Section 457, a tax-sheltered or tax-deferred annuity plan under IRC Section 403(b), or other tax-sheltered plans. Although, the contribution used to purchase service on a tax-deferred basis is not counted as this type of contribution, limitations for these plans are also based on your taxable income. Purchasing prior service credit on a tax-deferred basis reduces your taxable income, so the maximum amount you could contribute to other tax-sheltered plans could be reduced. VRS recommends you check with your financial advisor before initiating a tax-deferred purchase of prior service credit.