RETIREMENT NEWS

NEBRASKA SCHOOL, JUDGES, AND PATROL PLAN MEMBERS | *SEPTEMBER 2018* | NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEMS

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School

TERMINATIONS PRIOR TO RETIREMENT AGE

What are your options if you terminate service before becoming eligible for monthly retirement benefits? There are decisions to be made, but be aware... making the wrong choice can result in loss of benefits or nasty tax consequences!

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State Patrol

SERVICE CREDIT

Service credit (years of service) is one of the main factors used to determine vesting and calculate benefits for Patrol members. For members eligible to receive an unreduced benefit, each year of service credit will replace 3% of their final average salary. The maximum benefit under plan provisions is 75% of the final average salary which would be reached at 25 (or more) years of service credit.

Per state statute, to earn service credit a Trooper must be:

- Providing service as member of the Nebraska State Patrol Retirement System; and
- Contributing to the plan.

Service credit is **not** earned when a member does not make retirement contributions. For example, contributions are not deducted and service credit is **not** earned if:

- A member goes on a leave of absence;
- A member takes leave without pay;
- A member is placed on an unpaid suspension;
- A member is paid worker's compensation benefits; or
- A member has any other periods where they are not contributing to the plan.

To help us maintain accurate service credit, Troopers should contact NPERS in writing if they experience any of these non-contributing situations.

Service credit is accrued upon the start of plan participation in monthly increments. Members receive one year of service credit for each year that elapses from their plan entry date. Partial credit is granted if a member terminates employment prior to the anniversary of the plan entry date, rounded to the nearest month.

Troopers may make a one-time, written request for a tentative verification of service from NPERS up to one year but no less than 180 days prior to retirement or entering DROP. Troopers submitting this request should disclose any:

- Periods of leave without pay.
- Leaves of absence.
- Suspensions without pay.
- Period where they received worker's compensation benefits.
- Any period when they were not contributing to the plan.

NPERS will corroborate the information with the State Patrol Business Office to tentatively verify service credit. Service credit accrued and leaves without pay taken after the tentative verification will be reviewed by NPERS when we receive the Trooper's application for retirement.

Troopers who do not request a tentative verification of service, will have their service credit verified by NPERS when their benefit is calculated.

IRA | ROTH OR TRADITIONAL

If you elect to contribute to an IRA, you must decide if you want to utilize a Traditional or Roth IRA. Both are good options to save additional funds for retirement, and both offer tax saving advantages – but is one a better choice than the other? The contribution limits for both options are the same. In order to determine which is the better choice, you need to consider differences in taxation and ask yourself… which option will provide you with the most after tax income during retirement?

A Traditional IRA provides tax savings in the form of "pre-tax" contributions. Money you contribute can be taken as a deduction, which lowers your Adjusted Gross Income and reduces your taxes for that year. The account grows tax-free and when you take distributions, all withdrawals, including contributions and earnings, are subject to state and federal income taxes.

Contributions to a Roth account are made on a "post-tax" basis. You pay taxes up-front and contributions cannot be deducted from your yearly income, but when you reach retirement age both the earnings and contributions can be withdrawn tax-free.

THE GOAL OF "MORE MONEY" – IT'S COMPLICATED…

One of the common assumptions often made is a Roth will provide more money at retirement. This may or may not be true. Let's compare a Roth vs. a Traditional IRA using an average income tax of 25% and 5% rate of return for each account. When the tax rates and the rates of return are identical, would one option put more dollars in your pocket during retirement?

For this example, both of our savers have reviewed their budgets and determined they can afford to contribute about $75 each month.

The Roth saver will pay taxes first, and then make the monthly post-tax contribution to the IRA. At a 25% tax rate, in order to contribute $75 they must earn $100. $25 will be paid in taxes and the remaining $75 contributed to the Roth IRA. At retirement, the distributions will be tax-free.

The Traditional IRA saver will pay taxes when they take distributions, but because they are not paying taxes up front, the $25 dollars that would have gone to taxes can instead go into the IRA. Their $100 contribution will result in the same $75 reduction as the Roth saver.

Now let's apply the 5% rate of return over a 20-year timeframe* and then deduct the 25% in taxes the Traditional IRA saver would pay on distributions during retirement.

ROTH
Post-Tax Monthly Contribution = $75
After 20 years & 5% return = $30,827.53*
Account is tax free = $30,827.53

TRADITIONAL
Pre-Tax Monthly Contribution = $100
After 20 years & 5% return = $41,103.37*
After 25% tax = $30,827.53

In both examples our savers have earned $100 in income but the Roth saver gives up 25% of this to taxes which reduces the amount they can contribute each month. Our Traditional IRA saver must pay taxes when they take distributions, but if they are taxed at the same 25% rate, they end up with the same $30,827.53. The argument can be made that the Roth saver essentially paid less overall in taxes but what tangible financial benefit did they gain? If both savers contribute an equal amount, say $100, then the Roth does provide more funds at retirement – *but failure to increase the contribution rate when participating in a Traditional IRA diminishes the tax benefit it provides.*

TAXES – A BIG PART OF THE EQUATION.

So all things being equal, which option is going to provide you the most income for retirement? It all revolves around what percentage you end up paying in taxes. As your Adjusted Gross Income (AGI) increases, so do your

FILING STATUS SINGLE	
2018 AGI BRACKETS	**TAX RATE**
$0 – 9,525	Taxed at 10%
9,526 – 38,700	Taxed at 12%
38,701 – 82,500	Taxed at 22%
82,501 – 157,500	Taxed at 24%
157,501 – 200,000	Taxed at 32%
200,001 – 500,000	Taxed at 35%
500,001 – above	Taxed at 37%

MARRIED FILING JOINTLY	
2018 AGI BRACKETS	**TAX RATE**
$0 – 19,050	Taxed at 10%
19,051 – 77,400	Taxed at 12%
77,401 – 165,000	Taxed at 22%
165,001 – 315,000	Taxed at 24%
315,001 – 400,000	Taxed at 32%
400,001 – 600,000	Taxed at 35%
600,001 – above	Taxed at 37%

Can you manage your income to pay taxes at a lower rate? If you assume your taxable income during retirement will be lower, it may make sense to take the tax break now by contributing to a Traditional IRA, then pay taxes on the distributions during retirement – at the lower rate. If you believe your taxable income/rate will be higher during retirement, then the tax-free distributions of the Roth may be a better option.

Unfortunately, trying to determine what your income and tax rate will be during retirement is at best, a guess. These brackets represent the 2018 tax code. Your sources/amount of income, deductions, expenses, and future changes to the tax codes will all work for or against you.

SO MANY THINGS TO CONSIDER...

How much of your retirement income will come from taxable sources? Will distributions from these accounts push you into a higher tax bracket? During retirement there will be times when you may take a larger than usual distribution to replace an aging automobile or go on that dream vacation. Having funds in a Roth account allows you to cover all or part of those major expenses with tax-free distributions, thereby keeping your taxes in a lower bracket/rate.

You may have fewer items to deduct during retirement. For example, getting the house paid off is a wonderful thing, but how will losing that deduction impact your taxes? On the flipside, not having monthly mortgage payments may enable you to maintain the same standard of living with less income – potentially maintaining the same (or even a lower) tax rate. Review your current deductions and expenses and consider how they will impact your tax rates and income needs during retirement.

Will Social Security affect your income and tax rates? Under current law, Social Security benefits are subject to income tax at certain income thresholds determined by adding your AGI, plus any nontaxable interest, plus ½ of your annual Social Security benefit. Once you exceed these income limits, either 50% or 85% of your Social Security benefit will be subject to income taxes. The tax rate is determined by the applicable tax bracket IE: 10%, 12%, 22% etc. If taxable distributions and earnings are not reduced, adding Social Security benefits to the mix could result in increased taxable income and push you into a higher tax bracket. For some retirees, their Social Security benefits may reduce the need for taxable distributions or earnings, and result in lower taxes.

Roth IRAs do not force a required minimum distribution (RMD) be taken each year but they must be taken from a Traditional IRA. How will these distributions impact your tax rate during retirement? The highest distribution amount begins at age 70½, at which point a retiree with a Traditional IRA would be required to withdraw approximately 3.65% to fulfill the required minimum distribution. For lower or middle income retirees, these withdrawals may not be large enough to push a portion of their income into a higher tax bracket.

Under the current Nebraska tax code, earned income and distributions from a Traditional IRA are subject to state income tax. What if you plan on moving to a state with no state income tax during retirement? If the answer is yes, distributions from a Traditional IRA would be subject to federal but not state income taxes. If that is the case, would you be better off contributing to a Traditional IRA now?

What is your current tax rate? Are you just starting out your career and anticipate earning more as you advance beyond entry level positions? If you fall into the lowest tax bracket now but expect to earn more in the future, then contributing to a Roth may make more sense at this stage of your life. If your income increases to the point where you fall into a higher tax bracket, then switching contributions to a Traditional IRA may become the better option.

What about Medicare premiums? Premiums are based on income, and a large distribution from a Traditional IRA can result in higher premiums. Under current law, distributions taken from a Roth IRA will not count toward these income thresholds. For 2018, you will pay a higher premium if your modified adjusted gross income from 2016 was more than $85,000 (single filers) or $170,000 (joint filers).

Do you want to pass an inheritance to your spouse or children? One of the benefits of a Roth IRA is the ability to bequeath those dollars on a tax-free basis. If your heirs' income tax rates fall into the lower brackets, they may be better off inheriting a Traditional IRA rather than a Roth. Remember the example above – the larger account balance in the Traditional IRA has the potential to provide a greater overall benefit if taxed at a lower rate. Be aware the tax implications of inheriting any IRA can be complicated. Beneficiaries may need professional assistance to limit their tax liability.

SO WHAT IS THE ANSWER? TRY A BLEND OF BOTH?

Each individual situation is different and this article only covers a few of the circumstances you may encounter. For many individuals, the best choice might be to employ both a Traditional and Roth IRA. Even if you think your tax rates during retirement will be lower, having a portion of your nest egg in a Roth IRA provides additional flexibility to manage your taxable income during retirement. In the end, there really is no wrong choice! Both Traditional and Roth IRA's are excellent options to save for your future.

Calculations made using the U.S. Dept of the Treasury "Savings Planner" calculator.

BENEFIT ELIGIBILITY

To begin, let's discuss benefit eligibility. When are you able to receive monthly retirement benefits?

First off, you have to be vested. For most members, this is established when they accrue five (or more) years of service credit. Once vested, your age (when you start receiving benefits) and your years of service determine when you may begin drawing reduced or unreduced benefits.

AGE 65

Vested members are eligible for unreduced benefits at age 65.

RULE OF 85

Members may receive unreduced benefits prior to age 65 if they meet the "Rule of 85." Members participating in *Tiers One, Two, or Three* reach this status when:

- They attain the minimum age of 55, and;
- Their age plus service credit equals 85 (or more).

Members participating in *Tier Four* reach this status when:

- They attain the minimum age of 60, and;
- Their age plus service credit equals 85 (or more).

EARLY "REDUCED" RETIREMENT

Vested members who do not meet the Rule of 85 may receive reduced benefits as early as age 60. There will be a 3% per year reduction for each year their age is less than 65. For example, if a member begins reduced benefits at age 60, there will be a 15% benefit reduction. Be aware this is a permanent reduction.

YOUR OPTIONS

DEFERRAL

Vested Member

You may wait until you reach benefit eligibility and then apply for your monthly benefit. Benefits will be calculated using the salary, and service credit you accrued, as of your termination.

Two SUPER IMPORTANT points:

- It is your responsibility to apply for benefits. Contact NPERS at least one but preferably no more than six months prior to reaching eligibility.
- Monthly benefits will not increase once you attain eligibility for an unreduced benefit. Waiting beyond that point will result in the loss of potential benefits!

Unvested Member

You may defer your account, *but unvested members are not eligible to receive a monthly retirement benefit*. If you return to employment at your prior employer or begin qualifying employment at another employer participating in the plan, you will return to plan participation. Contributions will be deducted from your pay and you will resume earning service credit. If, however, you never accrue enough service credit to vest your account, your only option is a refund.

Required Minimum Distributions – HOW OLD ARE YOU!?

Federal tax laws require *terminated* members begin taking money out of their account at age 70½. At this age you must take a monthly benefit or refund. Failure to begin distributions could result in those nasty tax penalties.

REFUND – GAME OVER

You may withdraw your contributions and interest in a refund. Refunds can be paid directly to you, or rolled over to another eligible retirement plan or Individual Retirement Account (IRA). Be aware... refunds do NOT include employer matching contributions, and taking a refund erases your years of service credit and terminates plan membership.

Unless rolled over to another eligible retirement plan or Traditional IRA, refunds are subject to State and Federal income tax and there may be early withdrawal penalties if you take the distribution prior to age 59½.

WHAT SHOULD I DO NOW?

If you elect to take a refund, the refund request form is available on the School "Plan Info" page of the NPERS website.

If you decide to defer your account, be aware of when you will be eligible (and apply) for benefits! Also, please KEEP YOUR ADDRESS UPDATED WITH NPERS. If you fail to maintain an up to date address, your account may eventually be transferred to unclaimed property! A handy form is available on the "Forms" page of the NPERS website to report address updates or name changes to our office.

Please refer to the School plan handbook available at npers.ne.gov for more details on vesting, retirement age, benefit tiers, and other exciting retirement topics.

RETIREMENTS AND PREARRANGED RETURNS TO WORK

One of the main duties at NPERS is ensuring the plans we administer are in compliance with the Federal tax code. Failure to comply can result in fines and penalties assessed to the plan, employers, and plan members. Even worse, non-compliance could jeopardize the plan's tax-qualified status.

An ongoing compliance issue is reemployment after retirement. Reemployment after retirement is defined as providing service for ANY employer participating in your plan, after taking a retirement benefit (or refund).

The Federal tax code and State statutes require participants in the School, Judges, & Patrol plans terminate employment prior to taking a refund or retirement benefit. State statutes require a "bona fide separation from service" and establish break in service time frames of 180 days for School members and 120 days for Judges and Patrol. A member shall not be deemed to have terminated employment if they subsequently provide service (temporary, part-time or full-time, paid or voluntary) for any employer participating in the plan within those time frames. (School plan members may be able to provide limited, intermittent subbing during this time frame – please refer to the plan handbook for more information.)

It has come to the attention of NPERS that prior to (or at) retirement, some employers and employees are pre-arranging (written or verbal) returns to service after the 180 or 120 day break in service time frames. This is a violation of both State and Federal law! The IRS has advised plan sponsors to prohibit these arrangements or risk penalties and potential loss of tax-qualified status.

YOUR EMPLOYER CANNOT "HOLD" A POSITION OPEN FOR YOU AFTER YOU BEGIN RETIREMENT BENEFITS – REGARDLESS OF THE TIME FRAME.

A retired employee who provides service (paid or voluntary) in a position they previously held will definitely give the impression there may have been a pre-arranged agreement to return to work. If it appears there was a pre-arranged return to work, NPERS will conduct an inquiry into the circumstances surrounding the member's return to work. The member and employer will be asked to certify in writing if there was, or was not, a pre-arranged agreement. If this was an actual retirement, the member and employer will also be asked, "What process was taken to replace the "retired" employee?" and other similar questions to help NPERS understand the unique facts and circumstances of the case. After the inquiry has been completed, NPERS and the Public Employees Retirement Board will determine if there was a bona fide separation from service, or a pre-arranged return to work.

If **at any time** it is determined a School, Judges, or Patrol plan member did not experience a bona fide separation from service, or there was a pre-arranged agreement to return to work, three steps shall be taken:

1. **NO FURTHER BENEFITS WILL BE ISSUED.**
2. **ANY "MISSED" CONTRIBUTIONS MUST BE MADE UP BY THE MEMBER AND EMPLOYER.**
3. **ALL BENEFITS PREVIOUSLY ISSUED – INCLUDING ANY TAXES WITHHELD – MUST BE REPAID BY THE MEMBER.**

These repayments could amount to hundreds of thousands of dollars if the non-compliance is discovered after the member has received several years of benefits. Failure to repay can result in garnishment of wages, checking and savings accounts, and other retirement assets.

Reemployment after retirement is a complex topic and one that can lead to unwelcome consequences for non-compliance. Members are encouraged to refer the their plan handbook for additional "plan specific" information on reemployment requirements. Members and employers are welcome to contact our office if they have additional questions or concerns.

2018 LEGISLATION | *School, Judges, Patrol*

During the 2018 legislative session, one bill impacting the School retirement plan was passed and signed into law. The provisions of LB 1005 affects employers who remove members from plan participation, and the vested status of those members.

When services such as busing, food service, etc. are transferred to outside contractors, the employees providing those services are generally terminated from school employment. If these individuals are no longer school employees, they lose eligibility to participate in the school retirement plan. Even if they are hired to fill their prior position, as private sector employees, they are not eligible to participate in the school plan. They would cease contributing to the plan and accruing additional years of service credit.

Removing actively contributing members from plan participation removes benefit eligibility for members who have not attained vested status, and may affect the funded status of the plan. LB 1005 addresses these issues.

When a participating employer removes all or a portion of their employees from plan participation, the Public Employees Retirement Board (PERB) can require an actuarial study be conducted to determine any negative impact on funded status. A participating employer who is contemplating removing employees from the plan can submit a request to the PERB to conduct an actuarial study to determine the cost of their contemplated business decision. In either situation, the employer will be required to pay for the actuarial study, and will be responsible for all financial liabilities incurred by the plan. Those employees removed from participation would be vested in the plan regardless of years of service accrued.

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