

FREQUENTLY ASKED QUESTIONS

DROP LUMP SUM PAYMENTS

(REVISED JULY 2011)

Where may I roll over the lump sum payment?

You may roll over the payment to an IRA (an individual retirement account or individual retirement annuity), another qualified plan, a section 403(b) annuity or account, or a governmental section 457 plan. A governmental section 457 plan may not accept a rollover from a qualified plan unless it agrees to separately account for amounts rolled into it.

How can a lump sum payment affect my taxes?

You will be taxed on a payment from PSPRS if you do not roll it over. We are required to withhold 20% of the taxable amount at the time of distribution (see IRC 3405(c)(1)(B)). In addition, when you file your federal tax return, you will be subject to the 10% early distribution penalty unless the separation from service occurs during or after the calendar year in which the qualified public safety employee attains the age of 50 (Public Safety exception). However, if you do a rollover, you will **not** have to pay tax until you begin receiving withdrawals from the rollover account.

What is the Public Safety exception to the 10% penalty?

Distributions from certain governmental defined benefit plans made to public safety workers who separate from service after age 50 are not subject to the 10 percent penalty tax on plan distributions. A qualified public safety worker is any employee of a state or political subdivision of a state that provides police protection, firefighting services, or emergency medical services. To qualify for the exception the public safety employee must have received a distribution from a governmental defined benefit plan after separating from service, and the separation from service must have occurred during or after the calendar year in which the qualified public safety employee attained age 50. For example, a qualified public safety employee who separated from service on June 30, 2010, and attained age 50 on December 12, 2010, is eligible for the exception.

How do I do a rollover?

You should contact the IRA sponsor or the administrator of the employer plan for information on how to do a direct rollover. PSPRS will make the payment directly to your IRA or employer plan based on directions from you.

How much may I roll over?

If you wish to do a rollover, you may roll over all or part of the amount eligible for rollover. PSPRS can tell you what portion of a payment is eligible for rollover.

If I don't do a rollover, will I have to pay the 10% additional penalty tax on early distributions?

You must qualify for the Public Safety exception (age 50 or older during the calendar year of retirement) in order to avoid the 10% penalty tax on early distributions. In addition, you will be responsible for regular income tax on the payment not rolled over (we are required to withhold 20% for federal taxes at the time of distribution).

If I do a rollover to an IRA, will the 10% additional penalty tax apply to early lump sum distributions from the IRA?

Yes. The Public Safety exception applies only to amounts distributed from a governmental defined pension plan and does not apply to subsequent lump sum distributions from an IRA. If you roll over to an IRA, the rules relevant to an IRA plan are followed and generally you will not be able to take a distribution prior to age 59 ½ without penalty. (Certain exceptions apply that are only available for IRA's.)

If I do a rollover to a 457 plan, will the 10% additional penalty tax apply to early lump sum distributions from a Section 457 plan?

Yes. The Public Safety exception applies only to amounts distributed from a governmental defined pension plan and does not apply to a subsequent distribution from a 457 plan. There is a special rule for rollovers to Section 457 plans that requires the 457 plan to separately account for rollovers from qualified plans. Although the 457 plan is required to maintain a separate account for rollover amounts, the Public Safety exception will no longer apply to the rollover if withdrawn as a lump sum from the 457 plan before age 59 ½.

What about the "Retirement after Age 55" rule?

Plan participants who have separated from service after reaching the age of 55 are not liable for the 10% penalty tax for distributions made by a qualified plan. This is not relevant for Public Safety employees because they have the special exception at age 50.

An example would be if a police officer retired after reaching age 50, rolled his DROP money into a 457 plan, and withdrew the proceeds as a lump sum when he reached 55. He would be liable for the 10% penalty. This is so because the "normal retirement age" exceptions (50 or 55) apply at the time of retirement or leaving employment. When an amount is rolled over the exceptions to the additional income tax on premature distributions are determined by the receiving plan.

Will the 10% additional penalty tax apply if I was younger than age 50 at the time I retired and rolled my DROP money over even if I am age 50 or older at the time I receive my lump sum distribution?

Yes, the 10% additional penalty tax will continue to apply to your distribution if you receive it as a lump sum until you reach age 59 ½, even if you are age 50 or older at the time you receive your distribution. This is true for an IRA or 457 plan. There are certain exceptions, depending on the recipient plan.

These FAQs are provided as general information only and should not be construed as tax advice. We strongly encourage you to consult with your professional tax advisor before taking a distribution from an employer plan to determine how a distribution from the plan may affect your individual situation.

You can also find more detailed information on the federal tax treatment of payments from employer plans in IRS Publication 575, Pension and Annuity Income, and IRS Publication 590, Individual Retirement arrangements (IRAs). These publications are available from a local IRS office, on the web at www.irs.gov, or by calling 1-800-TAX-FORM.