

# HIGHLIGHTS OF INCOME TAX CONSEQUENCES OF DEFERRING A PENSION INTO DROP



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You may be eligible to defer your pension into the Deferred Retirement Option Program (hereinafter "DROP"). If so, there are Federal income tax consequences that you should consider before making an election to defer into DROP. The Dallas Police and Fire Pension System ("System") cannot provide financial or legal advice to you or tailor these highlights to your particular situation. However, these highlights will discuss some of the income tax consequences that result from deferral into DROP by pensioners in various circumstances. You should consult a tax or financial advisor who has expertise in the Federal income tax treatment of annuities and distributions from qualified pension plans before electing to defer your pension into DROP.

Pension payments under tax-qualified plans such as the Combined Pension Plan are taxed when you receive them in much the same way as your salary was taxed before retirement. However, the part of the pension payments considered to be a return of the pensioner's own after-tax member contributions is eventually recoverable tax-free. Any pension payments that you elect to defer into DROP will not be taxed until they are paid to you out of your DROP account. This can be attractive to you if you are working and in a higher tax bracket now but expect to be in a lower tax bracket when you receive your DROP distribution. Unfortunately, deferring your pension into DROP can cause you to pay more Federal income taxes in certain cases.

If you elect to defer your pension into DROP and amounts are deducted for any reason, such as to pay premiums on your health insurance, the amounts deducted will be subject to tax. These amounts are treated as annuity payments because they will be paid by the System in substantially level monthly payments.

More importantly, the Internal Revenue Code imposes an additional early distribution tax with respect to certain payments received by a pensioner before age 59 ½. The early distribution tax is ten percent (10%) of the taxable pension received. This additional tax does not apply if you qualify for one of several exceptions to this tax law. For example, you do not owe this additional tax if: 1) You terminate Active Service with the Police or Fire Department on or after the date you attain age 50 (age 55 if you left Active Service before August 17, 2006), and/or 2) You terminate Active Service before you attain age 50, but receive only your monthly pension payments until after you attain age 59 ½.

Eligibility for the second exception to the ten percent (10%) early distribution tax may be adversely affected by a change in the amount of the payments, such as an election to defer your pension into DROP or take distributions from your DROP account after you started to receive monthly payments. Based on guidance available from the Internal Revenue Service at this time, liability for the additional tax is affected by your age at the time you leave Active Service and whether you leave Active Service after August 17, 2006. If you leave Active Service in or after the year you attain age 50 and after August 17, 2006, a later election to defer your pension into DROP will not

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subject your benefits to an early distribution tax; furthermore, if your pension is not yet in pay status, that is, you have elected to defer your pension into DROP, you will not owe a ten percent (10%) early distribution tax on any pension payments held in your DROP account.

If you leave Active Service before the year you attain age 50 and commence to receive a monthly pension, any election to defer your pension into DROP before you attain age 59 ½ may result in imposition of a tax equal to 10% of the taxable pension payments you have received. Even if you were age 50 at the time you left Active Service but you were not age 55 and you left and commenced to receive your pension before August 17, 2006, an election to defer your pension into DROP at any time before you attain age 59 ½ could subject you to the additional tax on the taxable pension payments you received before August 17, 2006 plus interest.

Similarly, if you left Active Service before you attained age 50 and you revoke your DROP deferral election before you attain age 59 ½, you may owe early distribution taxes on any taxable deductions that have been made during the deferral period and on the taxable pension and DROP payments received in the year of the revocation.

Of course, the tax treatment of your pension is only one of the considerations you should take into account before electing to defer your pension into DROP. However, it is a very important economic consideration and you may want to time any election you make so as to minimize adverse tax treatment.