Buy Backs: Purchasing Service Credit with Rollover Money

By Rick Palmer, CFP® Vice President, Investments, Raymond James

Plan members usually have the option to buy additional years of service (up to 5 years typically) with rollover money from another plan. Effectively, they are given the option to finance additional credited service with other qualified plan assets, to increase their retirement benefit and possibly vest sooner. In this way, beneficiaries can be protected when a member achieves expedited vesting status, potentially guaranteeing them a monthly benefit in the event the member passes away during active employment (under a joint survivor arrangement). Whether a plan member chooses to buy back service credits largely depends on personal circumstances and how attractive the pension plan is.

Factors to Consider

• Whether the plan offers a COLA (Cost of Living Adjustment): The higher the COLA, the more attractive the plan.

• The multiplier of the plan: The higher the multiplier, the more attractive the plan.

• The member's Mortality Risk/Family History: The longer the plan member lives, the more sense it makes to buy additional service credit.

• The member's level of investable assets: the greater the plan member's investable assets, the more sense it makes to buy additional service credit.

In my opinion, the final two factors are particularly important because it would be sub-optimal for a member to purchase additional years of service at the expense of depleting his 457 account. On balance, it would be better to maintain some level of liquidity in the event of a financial emergency. In purchasing years of credit, the member is potentially risking that the opportunity cost of parting with his money in his 457 is less than the future gains from a greater pension.

A break-even analysis can be done to compare the 2 alternatives:

Hypnotical Example

Captain Smith is an active member in his city's pension plan and he's considering early retirement. He wants to buy 2 additional years of service at a cost of $6,252. The plan allows him to use his deferred comp (457) balance to finance this purchase. His estimated monthly retirement benefit is $3,214, compared to $3,384 per month if he bought 2 additional credited service years. The increased monthly benefit of $170 will pay for itself in approximately 3 years. Now let's assume he earned a 6% rate of return on his money in his 457 plan. Had he not bought the additional credited service, the increased value of his 457 would have allowed him to break even in 3 years and 3 months. If he were to live until age 75, he would receive $55,353 in additional monthly payments due to the extra credited years. Alternatively, he would need to have an additional $30,796 today to draw an additional $170/month over that same time period (still assuming a 6% annual return). This analysis excludes the effects of a COLA and illustrates that the longer he lives, the more compelling it is to buy additional credited service years.

Methods of Payment

Pension plans usually prefer payments for service credit to be from qualified plans. The member arranges to roll or transfer money from his defined contribution account (i.e. 457(b) or traditional IRA). Depending on the rules of the plan, other qualified plans may be acceptable, but Roth IRA's may not eligible. The member also has the option to buy service credit with a personal check. However, the tax benefits of a rollover from another qualified plan are forfeited if the member pays in this manner. Consider contacting us to discuss your specific situation so we can design a comprehensive, customized plan for you and your family.

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