SOCIETY OF ACTUARIES

5. IRS and Administrative Issues

There are many tax issues that have been raised concerning DROP benefits. All of these issues require legal advice. Our experience is that not all lawyers (or actuaries) will agree on the correct tax treatment. However, we did not want to ignore these issues. Therefore, we have presented common issues that need to be addressed. Many of the Web sites shown in Appendix A contain descriptions provided by plans to DROP participants concerning tax treatment and options.

5.1 DB or DC?

One issue that is often raised is whether a DROP is treated as a DB plan or a DC plan. More specifically is it a plan defined under IRC Section 414(k)? Section 414(k) deals with plans that are both DB and DC in nature. For purposes of 415 limits and 72(d) tax treatment of employee contributions, 414(k) plans are "treated as consisting of a DC plan to the extent benefits are based on the separate account of a participant and as a DB plan with respect to the remaining portion of benefits under the plan, …" (see 414(k)(2)).

One initial view was that a DROP plan is a DC plan and that the "contributions" to the DROP account are annual additions. This would be a problem since the retirement annuity amounts ("contributions") can often exceed the DC limits. Few still hold this view. A more common view is that DROP accounts retain their DB nature since they are not technically separate accounts just as cash balance plan accounts are not separate accounts. This case is strongest where the interest rate credited is not exactly equal to the actual return of the fund (see 5.4 below).

The method of crediting interest to the DROP accounts might determine whether, for IRS purposes, they are considered DC components under IRC Section 414(k) or whether they are to be treated as a DB benefit. If the interest credited to the forward DROP plan accounts is the same as the rate earned by the actual assets underlying the accounts (even if adjusted for additional expenses), then the program may be treated as a DC component as described in Section 414(k). But if the crediting rate is fixed or some other method not directly related to the earnings of the actual underlying assets, then the program is treated as a DB for IRS purposes.

For example, noncontributory DB plans often used to permit voluntary after-tax employee contributions that were credited with the earnings of the underlying fund. These were treated as DC components of the plan. Rollover contributions or trustee-to-trustee transfers into a DB plan are typically established as accounts that are allocated earnings equal to the rate experienced by the underlying plan assets (if not used to purchase DB service credits). So DROP accounts may be treated as DC components under 414(k) if they are credited with earnings that are directly related to the earnings of the actual assets underlying the accounts. These DROP plans include those crediting the actual fund rate and those self-directed plans investing in mutual funds.

On the other hand, cash balance plans are treated as DB plans because their interest credits are not equal to the actual returns of the underlying assets. The same is true of any DB plan that has employee contributions credited with a fixed rate. So DROP accounts would be treated as an additional DB feature if they are credited with a fixed rate, assumed actuarial rate, smoothed rate or an index rate.

Might self-directed DROPs be treated as DB plans? Maybe. There are some cash balance plans that credit interest based on returns of employee selected indexes (e.g., mutual funds). Plan assets might not be invested in these actual funds. DROPs could be designed the same way and be treated as DB plans. Even if interest is tied to actual returns, some still argue they are DB plans.

5.2 415 Limits

Even with the DROP feature, the total benefit package is often viewed as a DB plan subject to the defined benefit limits. The annuity equivalent of the DROP lump sum plus the DROP annuity are generally added together to compare to the Section 415 defined benefit dollar limits. Given the high limits for public safety employees ($130,000/year at any age), Section 415 is rarely a problem.

If the DROP feature is considered part of a DB plan, then the benefits accrued and paid must be limited under IRC Section 415(b). When benefit payments are to begin, such as at the end of the DROP period, the lump-sum DROP payment should be converted to an equivalent normalized annuity using the assumptions specified for such purpose in 415(b) and added to the regular monthly annuity payable (also normalized) so that the total employer-provided benefit can be limited if necessary under IRC Section 415(b). This procedure would also be followed for back DROPs, PLOPs or other DROPs that are classified as DB features.

There seems to be a minority view that DROP accounts are to be treated as DC components under IRC Section 414(k). If this is the case, Section 415(b) limits would apply to the calculated monthly pension while Section 415(c) limits would apply to annual additions made into the DROP accounts.

The monthly DROP amounts can be thought of as plan-to-plan transfers from the DB plan to the DC component. IRC Section 415(c) limits the amount of annual additions credited to a DC account. These annual additions are, generally, defined to include employer contributions, employee contributions and forfeitures. The regulations specifically exclude plan-to-plan transfers from the definition of annual additions. Thus, while a participant’s DROP account may be considered as a DC component, the only item of annual additions that might be limited under 415(c) is any employee contribution that might be made to the account.

Keep in mind that post-tax employee contributions (plus interest on them) generally are not part of the DB plan’s Section 415(b) limitation for governmental plans. Also see Section 5.3.

Some have adopted the practice of limiting the amounts of the DROP “deposits” to the 415 DB limit then in affect. This would treat the deposits just as if it were paid to the participants.

5.3 Rollovers and Tax Basis Calculations

One of the favorable aspects of the DROP lump sum is that all of the plans we have seen say that it can be rolled over to an IRA. One detail to note is that some employees have made post-tax contributions in the past. These employees have a “tax basis” which can be recovered tax-free after retirement. This usually occurs as a portion of each annuity payment based on rules contained in Section 72 of the Internal Revenue Code. However, with a DROP plan there is an issue since part of the benefit is paid as an annuity and part as a lump sum. Some plans have allocated all of the tax basis to the annuity. However, most plans have allocated a portion of the benefit to the DROP lump sum and a portion to the annuity on the basis that both forms of payment are part of the same “contract.” Generally, the portion allocated to the DROP lump sum equals:

Tax basis x {DROP lump sum / (DROP lump sum + present value of annuity)}

The present value of the annuity is usually determined based on the plan’s actuarial equivalence basis. Prior to 2002, the portion of the tax basis allocated to the DROP lump sum could not be rolled over (nor subject to tax).

If the lump sum is paid out and is not rolled over, the extra 10% tax will apply if the employee is under age 55 at termination of employment (not 59.5 as long as retirement is allowed at age 55). Some attorneys think that if the 10% tax applies to the DROP lump sum, it also applies to the DROP annuity.

5.4 Self-Directed DROPs

A self-directed DROP is a special type of a forward DROP. The distinction is that in a self-directed DROP the employee gets to direct how the DROP lump sum is invested. Generally this is done by actually segregating funds for the DROP lump sum into an account that the employee can direct just as an employee might direct investments in a 401(k) or 457 plan. It is possible that funds might not actually be segregated but that indexes would be chosen that would be used to determine the interest rate (as is sometimes done in cash balance plans).

Many of the initial self-directed DROPs were in the state of Florida. A few have IRS determination letters. The following are common in self-directed DROPs:

- The number of investment options varies by plan from just a few to over 500. This is similar to what we see in DC plans. The number offered is a trustee decision.

- If a DROP is to be self-directed it is likely that an outside manager will be selected that has a “turn-key system” to administer the DROP plan. However, there is at least one plan that administers its own self-directed accounts. Funds directed by the employee remain assets of the plan and under the control of the trustees.

- It is more likely that DROP lump-sum accounts will be allowed to remain in the plan after termination of employment since the employer does not bear the investment risk associated with a fixed interest credit in a non-self-directed DROP.

- Statements are usually provided quarterly and Internet access is often provided.

- While not common, some plans offer a choice between a self-directed account and a non-self-directed account.

The need for legal advice is increased when looking to add a self-directed feature. Unfortunately, it may be some time before the IRS provides any formal guidance in this area. Also see Section 5.2.

5.5 Benefit Statements/Illustrations/Retirement Counseling

Prior to making a DROP election[1], eligible participants are usually given a booklet explaining the DROP provision and providing DROP illustrations. This is often accompanied with employee meetings to explain the options. Many plans have information on their Web sites. Ideally employees would have software available to allow them to do some “what if” comparisons, e.g., using different DROP election dates and salary assumptions.

Public plans do not have the ERISA requirement that employees be allowed to request a statement of their accrued benefit once per year. Benefit statements are not uncommon in public plans; however, poor data quality may cause plans not to issue statements to all members. DROP participants generally have had their data reviewed and estimated benefit calculations done prior to making a DROP election. Therefore most plans are in a position to issue DROP statements during the DROP participation period.

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[1] DROP election means to elect to participate in DROP and not an election between different forms of an annuity at time of retirement.

Some plans are able to fully determine (at the time of the DROP election) the exact month-by-month projection of the DROP lump sum and annuity at any point in the future. This is common if there are no COLAs, the interest credit rate is fixed, and there are no issues with sick leave credit. In other cases, annual or quarterly statements may be prepared to show actual COLA increases, variable interest rate credits and adjustments for sick leave accruals.

While it is best to get involved with retirement counseling early in one's career, many in attendance at employee meetings are often within five years of retirement. For some, retirement counseling is just an explanation of their options at the time they terminate employment. When a plan has a forward DROP, an election is made several years prior to termination of employment. Usually the plan administrator will want to have one-on-one and group meetings prior to a DROP election. The one-on-one counseling will often involve individualized projections of future benefits with and without a DROP election.

5.6 Recordkeeping/Administrative Expenses

Administering a DROP plan does require extra staff time. This can sometimes be minimized by adding a back DROP vs. a forward DROP feature; however administrative cost is usually not the most material factor in the design decisions. Keep in mind that extra expense means reduction in plan assets and higher plan sponsor cost.

Most plans that we have seen do not charge employees for the extra administration associated with the DROP accounting. Where this is most likely to occur is with self-directed DROPs where a vendor fee and an investment fee might apply.

5.7 Employment Treatment

No one can predict how all legal and employment issues about DROPs will be resolved, just as it would have been difficult in 1985 to predict legal issues for cash balance plans. Generally, DROP participants are entitled to the same pay, benefits and promotional opportunities as other employees. However, how they are viewed for pension purposes might be different.

Below are a couple of legal opinions that perhaps you agree with but should appreciate that other reasonable and informed people might come up with a different decision:

> Opinion of the Arkansas Attorney General on the question of: Is a police officer participating in DROP considered retired for purposes of serving on the Arkansas Fire and Police Pension Review Board?
>
> Answer: Yes. Because of the manner in which the benefits of DROP participants are distributed, their interest in the pension system is more akin to the interest of retired members than to that of active members.

Many public sector boards of trustees have separate seats reserved for active participants vs. retired participants. Some “active” representatives are DROP participants. The issue of the DROP participant’s “interest” for representation purposes is an interesting one. Would it matter if the law specifically stated whether DROP participants get the benefit of future benefit improvements or whether they could accrue benefits after their DROP participation period?

> Opinion of Pennsylvania … on the question of state aid:

The state of Pennsylvania provides an allocation of state aid directly to local retirement systems based on the number of active participants. The State Law (Act 205) classifies members as either “active” or “retired” with no classification for DROP participants. The state decided that DROP participants are not active for state aid purposes. This was apparently based on the concept that DROP participants are not earning any benefits. This does not address the issue that participants are actually losing value without a DROP and even though this total retirement benefit may be increasing more rapidly with DROP than it would without DROP. A proposal was made to change the law to clarify the situation. Also see Section 3.3.

5.8 ADEA

This is an emerging issue. Like the other legal issues discussed in this study, our intent is not to give legal advice but to make the reader aware of issues and common practice.

In December 2002, the Treasury issued a proposed regulation covering age discrimination issues in both traditional and cash balance plans. One of the examples dealt with providing actuarial increases after NRD in a traditional plan. That illustration provides the context of the following example.

Assume there is a fire and police plan that provides a benefit of 2.5% of final average salary per year of service and has an NRA of 50. Therefore, the accrued benefit after 20 years is 50% and after 23 years is 57.5% of final average salary. Now assume you have two different employees, both with 23 years of service but one age 50 and the other age 53. Assume that the 53-year-old elected DROP three years ago. Now also assume that the DROP ratio for the 53-year-old is less than 100%. This implies that the 53-year-old's benefit is worth less than 57.5% of final average salary. This would also mean that the 53-year-old's benefit is less than the 50-year-old's benefit (thus the age discrimination problem).

Two things to keep in mind: (1) age discrimination rules apply to public and private sector employers and (2) providing an employee the choice between a legal and illegal option does not make the election of an illegal option legal.

The issue of DROPs has been proposed to the Treasury and hopefully some guidance will result.