

DEFERRED RETIREMENT OPTION PLANS ("DROP" PLANS)

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IN recent years, many retirement plans, particularly those operated by state and local governments, have adopted some form of deferred retirement option, or "DROP," plans. This article discusses what a DROP plan does, what the attraction of a DROP plan is from the perspective of both the employer and the plan member, and the legal and actuarial issues raised by DROP plans.

What is a DROP Plan?

In its simplest terms, a DROP plan is an arrangement under which an employee who would otherwise be entitled to retire and receive benefits under an employer's defined benefit¹ retirement plan instead continues working. However, instead of having the continued compensation and additional years of service taken into account for purposes of the defined benefit plan formula, the employee has a sum of money credited during each year of the continued employment to a separate account under the employer's retirement plan. The account earns interest (either at a rate stated in the plan, or based on the earnings of the trust underlying the retirement plan). The account is paid to the employee, in addition to whatever benefit the employee has acquired under the defined benefit plan based on earlier years of service, when the employee eventually retires.

An example may make the arrangement easier to understand. Suppose that employee X is covered by a retirement plan which provides that she will receive an annual benefit beginning at retirement of 2% of average final compensation² times years of service. Suppose further that the retirement plan permits employee X to retire as early as age 55 with 30 years of service, without actuarial reduction for the early retirement. If employee X had average final compensation of \$20,000 a year at age 55, and had achieved thirty years of service at that point, she could retire immediately with a benefit of 2% x 30 (years of service) x \$20,000, or \$12,000. In the alternative, she could continue working until, say, age 60. At that point, she would have 35 years of service instead of 30, so the benefit would have gone up from \$12,000 to \$14,000, even if her compensation had stayed exactly the same. And of course, the benefit would have risen further if compensation had gone up between ages 55 and 60.

A DROP plan would provide employee X with a third alternative. Instead of retiring immediately on a \$12,000 a year benefit, or deferring retirement and getting a \$14,000 annual benefit at retirement, she could elect to continue working for five years, but to have her compensation and years of service frozen at the level they were when she was 55. In exchange for her giving up the right to the continued accrual, her employer would agree to put \$12,000 for each of the five years of her continued employment into a separate account under the retirement plan for her. When she ultimately retired, she would receive (a) \$12,000 a year, plus (b) the value produced by taking the \$12,000 a year credited to the account and increasing it by an earnings factor.

Within this basic format, plans may implement many different options. For example, in some instances a COLA or a "thirteenth check" (an additional payment each year equal to one month's benefits) will be applied to the basic benefit. In some instances, the employer and/or the member will make additional contributions to the account over the period of continued employment. The methods for crediting interest vary widely: earnings may be credited at a "formula rate" (e.g. the funding rate for the plan), at a fixed rate set forth in the plan, based on an independent index (e.g., T-bill rates), at a rate which depends on the discretion of the employer or some other party³

(e.g., the trustees in IRS Letter Ruling 9645031), or based on actual earnings (either of the plan as a whole, or of an individually directed account). In some instances, the member can obtain the DROP benefit only by foregoing the right to continued employment at the end of the DROP period.

Why Would An Employer Consider a DROP?

To the extent that employers are initiating DROP Plans, the major reason is a concern about the ability to retain valued employees who are eligible to retire. Many governmental plans, either as a matter of plan design or due to inadvertence, contain substantial incentives for employees to retire early. For example, employee X was making \$20,000 a year by working full-time, yet could have received a \$12,000 a year retirement benefit. Thus, she was getting only an extra \$8,000 a year for working full-time over what she could have received for not working at all. Moreover, if employee X had switched to a job in the private sector, even one which paid only \$15,000 per year instead of \$20,000, she could normally have received the full \$12,000 a year retirement benefit, *in addition* to her \$15,000 salary. Thus, even though the private employer paid her less, her total income would be \$27,000 a year, instead of the \$20,000 a year she would make in her public-sector job.

In many instances, situations like that of employee X arise because the employer (or the plan to which the employer contributes) wanted at some point to encourage early retirement. This is particularly true in the case of public safety employees (who may lack the physical stamina to keep up with their demanding jobs at later ages) and teachers. During the teacher surpluses of earlier years, many school systems tried to get more experienced (and therefore more highly paid) teachers off the payroll to make way for less experienced (and therefore less expensive) replacements. However, in many instances employers have found that they have thereby discouraged some of their most loyal and productive employees from continuing to work.

Why Do Employees Like DROP?

In some instances, an employer adopts DROP as a result of pressure from employees or unions, or as a tool in labor negotiations. A DROP plan is often quite popular with employees. It enables those employees who may have "maxed out" on the benefit payable under a defined benefit plan to continue to accrue benefits. Even for those who have not maxed out, the rate of accrual is often more favorable than continued accrual under the defined benefit arrangement. In many instances, the DROP benefit is payable as a lump sum (always a popular feature with employees), while the defined benefit is available only as a lifetime annuity.

Cost Considerations of Plan Design

In order for a DROP Plan to be successful there must be a give and take between the employers and employees. As noted earlier, the DROP Plan enables an employer to retain valuable employees and enables the employee to accumulate a larger pension than would otherwise be payable under the existing defined benefit pension program. But at what cost?

Actuarially neutral design. Most simply put, increases in pension benefits above those currently provided cost more money. Many DROP programs strive to be "actuarially neutral." If a DROP Plan is provided as an overlay to the existing retirement program as an actuarially equivalent option, offered to everyone, then there should be no direct cost for the program. Actuarial costs, however, are only truly measured with experience. If, for example, the addition of a DROP program causes employees to begin to retire earlier, then the cost to the employer will necessarily increase since pensions will need to be funded over a shorter period of time. On the other hand, since employers generally fund retirement programs over the working lifetime of the participants, employer contributions would be expected to continue until the employee actually

stops working. But if the plan is designed that when a DROP option is chosen, an employer ceases to make pension contributions for the employee, then the employer has an immediate contribution savings during the DROP period.

The effect of demographics on design. Of course, all bets are off if the underlying retirement program provides actuarially subsidized early retirement benefits, a common practice in the governmental plan arena. Subsidized early retirement benefits (that is, benefits for early retirements which are unreduced or reduced less than actuarially neutral benefits) produce an increased cost to the employer. When an employee who is eligible for a subsidized early retirement benefit decides to continue to work for another year, the pension plan experiences an actuarial gain since it need not provide the pension payments for that year. The longer the employee continues to work, the larger the actuarial gain to the plan. These actuarial gains serve to lower the ongoing employer cost of the plan.

But examine what happens with the addition of a DROP program. From the pension plan's viewpoint, when an employee chooses the DROP option, it is exactly as if the employee has retired since actual pension payments will begin. If the pattern of incidence of retirement changes under the DROP Plan, then from an actuarial standpoint, the assumptions concerning retirement may need to be revised to take this actual experience into consideration. Using lower assumed retirement ages will result in higher required contributions to properly keep the plan in balance.

Most government plans mandate employee contributions which are used to offset the employer cost of the plan. Design choices regarding these contributions can affect the ongoing cost of the retirement program. If the employee contributions continue during the DROP option period, the employer contribution continues to be offset. But, if the employee contribution ceases at DROP choice or is also deposited into the DROP account, then the total cost portion normally funded by the employee must come from the employer.

The effect of investment return on design. Defined benefit pension programs benefit not only from retirement gains, but also from investment gains. The actuary, in preparing cost calculations, assumes that assets will earn a stated net investment return. Since employers bear the risk of investment in defined benefit plans, to the extent that the plan assets earn a rate higher than that assumed by the actuary, the fund experiences an actuarial investment gain which serves to lower the ongoing employer contribution. Compare this to the defined contribution arrangement, where the amount of benefit received by the employee is directly related to the employee's account balance and this account balance is credited with the actual investment return of the fund.

If a DROP Plan credits interest based on actual earnings, then the employer has passed on the full investment risks to the employee. Therefore, in a strong investment market, the employer's cost for the remaining defined benefit program will increase as there are no investment gains to offset the pension cost. In a weak market, the employee's ultimate total pension benefits could be less than if the DROP option were not chosen.

A numerical example. In our earlier example, if the DROP were chosen, Employee X would have an additional lump sum of \$60,000 (5 years of \$12,000) plus interest credits available at age 60 and the right to receive \$12,000 a year for the balance of her lifetime (option 1) compared to receiving \$14,000 a year for her lifetime (option 2). The present value of the future payments under option 2, assuming a 30 year period of payments and 7% interest, is about \$185,900. The present value of the future pension payments under option 1 is about \$159,300. The net gain to Employee X of exercising the DROP (option 1) is \$33,400 plus interest credits on the 5 years of invested pension payments. (\$159,300 plus \$60,000 plus interest credits minus \$185,900). It seems as if the employee is the big winner in a DROP Plan.

Why is this so? In our example, the early retirement benefit is subsidized, that is, there is no actuarial adjustment for taking the benefit at age 55 versus taking the benefit at age 60. In order for our example to produce an "actuarial neutral" pension benefit, the non-DROPPER should be given an actuarially increased benefit for retiring at a later time (or conversely, the DROP benefit should be actuarially reduced for earlier receipt). Neither of these adjustments are particularly common in governmental plans.

Bigger benefits cost the employer more and DROP plans generally provide bigger benefits.

Legal Issues

Contribution limits. As noted above, the earnings crediting on a DROP can take several different forms. The way in which earnings are credited will affect the legal rules applicable to the plan.

If interest is credited based on actual earnings, either of the plan as a whole or of an individually directed account, the portion of the plan which represents the DROP accounts is treated as a separate defined contribution plan. As such, it is subject to all of the rules applicable to defined contribution plans, including the rule in Code Sec. 415(c) that annual contributions cannot exceed the lesser of 25% of compensation or \$30,000. Obviously, our example of the employee who was earning \$20,000 a year, and having \$12,000 a year credited to the DROP, would be impermissible if the DROP were being credited with actual earnings.

If instead the DROP is credited with earnings at a stated rate, the DROP benefit is treated as part of the ultimate defined benefit for purposes of the maximum benefit limitations of Code Sec. 415(b). In general, these limits are less of a problem than the defined contribution limits, and for that reason among others, most DROPs are designed in such a way as to constitute defined benefit plans for Code purposes. However, even the Code Sec. 415(b) limits can be a problem for some highly compensated employees with long service—the exact ones to whom a DROP is likely to be most appealing.

Definitely determinable benefit rule. Another issue is the "definitely determinable benefits" rule set forth in IRS regulations under Code Sec. 401(a). This rule requires that benefits under a pension plan be determinable from the plan document, rather than being subject to employer discretion. In many instances, it is hard to develop an appropriate interest rate for a DROP benefit, since commercial interest rates may fluctuate over the life of the DROP. However, a rate based on employer or trustee discretion may be considered to violate the definitely determinable benefits rule.

Age Discrimination in Employment Act ("ADEA"). As discussed above, in many instances employees enter the DROP program based on an intent that they will in fact retire after a specified number of years. Entering the DROP program ceases normal benefit accruals, in favor of the special DROP benefit. One question is whether the decisions to retire at the end of the specified period, and/or to cease normal benefit accruals, can be made irrevocable without violating ADEA.

To the extent that (a) the decision to enter the DROP program is voluntary, (b) there is no maximum age limit for entering the DROP program, and (c) the DROP program is not being used as a subterfuge for getting rid of older employees, a DROP program of itself would not create an ADEA violation, even though its effect would of course be to cause older employees (typically, the only ones eligible for DROP) to leave employment earlier than they otherwise might.

However, certain features of a DROP program can cause ADEA issues. For example, if the program is available only between the earliest retirement age specified under the plan and normal

retirement age, it would discriminate against employees based on how close they were to normal retirement age. Similarly, if the DROP program were presented in a way which raised other ADEA issues (e.g., notifying older employees that if they did not accept it, they would likely be laid off anyway without the security of the DROP program), it might be part of a pattern which as a whole could raise ADEA issues.

The fact that the employee who is participating in DROP has not retired can also raise questions under ADEA. For example, if the employee had actually retired, s/he would not normally be entitled to disability benefits if s/he became disabled. However, someone who remains an employee and participates in DROP could potentially get the full economic effect under the pension plan of having delayed retirement, while still being eligible for disability benefits if s/he became disabled.

At a minimum, employers should ensure that any employee who accepts the DROP program subject to a requirement that s/he terminate employment as of a certain date signs an appropriate resignation letter (effective as of the proposed date of termination) as part of the process of obtaining the DROP benefit, and that such letter complies with all of the ADEA requirements for waiver of ADEA rights. And of course, other employment practices must be examined to ensure that they do not combine with the DROP to create an ADEA violation.

Moreover, many states have their own age discrimination statutes, in addition to ADEA. In general, the rule is that employees are entitled to their rights under ADEA and their rights under the state statute. Thus, an employer which complies with all the requirements of ADEA must still make sure that it complies with the corresponding provisions of applicable state law.

Distribution rules. Although employees who are in a DROP program often view themselves as "receiving" the amount of the plan contribution each year, the contribution is not itself treated as a distribution. This has positive effects insofar as it avoids the 10% penalty tax on early distributions and income taxes on distributions. It also means that employees who have attained early retirement age but not normal retirement age can participate in a DROP program without violating the rule that a pension plan may not distribute benefits (other than amounts attributable to after-tax employee contributions) before the earlier of normal retirement age or termination of employment.

However, the fact that the DROP contributions are not treated as distributions raises certain questions. First, the DROP contributions cannot be treated as fulfilling the required minimum distribution requirements under Code Sec. 401(a)(9). Although active employees are no longer required to receive such distributions, postponing the start of minimum distributions will increase the amount required to be distributed (possibly throwing the employee into a higher tax bracket) once the employee retires.

Similarly, there may be a question as to who is the spouse for purposes of plan survivor or death benefits if the employee remarries between the start of the DROP program and actual retirement. At a minimum, the plan needs to be clear on how such situations will be treated.

Social Security. Another consideration for lower paid employees may be the effect of a DROP on Social Security benefits. Amounts credited under a DROP, unlike normal wages, are not considered part of the wage base for Social Security purposes. For those employees who are close to retirement, the trade-off of the DROP program against the Social Security advantages which might accrue from having the employer simply pay higher cash wages instead may need to be considered.

Issues for nongovernmental plans. Governmental and church plans are not required to comply with the Employee Retirement Income Security Act of 1974 ("ERISA"), or with many of the Code

provisions governing qualified plans. ERISA § 4(b)(1) and (2); Code Sec. 401(a). However, DROP plans adopted by private sector employers need to consider a host of additional legal issues under both the Code and ERISA. For example, Code Sec. 411(b) and ERISA § 204(b) impose so-called "backloading rules," under which the benefits accrued in a particular year cannot exceed the benefits accrued in an earlier year by more than a particular factor set forth in the statute. A DROP plan might well have difficulty showing compliance with such rules. Code Sec. 401(a)(4) prohibits discrimination in favor of highly compensated employees. To the extent that those employees who are eligible for DROP tend to be more highly compensated than other employees, a DROP plan accrual more generous than the accrual available under the general defined benefit plan could run afoul of these rules. While the rules for private plans are beyond the scope of this article, it is important that private plans consider the full ramifications of a DROP plan under the Code and ERISA.

Conclusions

DROP plans can be very attractive to both employers and employees. However, employers must recognize that some of the features which make DROP plans most effective may also result in cost increases for the plan. And any DROP program must be carefully structured in order to avoid the various legal issues potentially presented.

FOOTNOTES

¹ A "defined benefit" plan is a plan which states the amount of benefits, typically as a percentage of compensation multiplied by years of service. It contrasts with a "defined contribution" plan, under which the ultimate benefit is derived from setting aside a defined amount of money each year, crediting it with plan earnings, and using whatever the resulting account balance is at retirement to provide the benefits.

² "Average final compensation" is typically defined as average compensation over the final three years of employment, although there are variants to this definition.

³ Note that in order for a discretionary interest rate not to fall afoul of the requirement that a pension plan provide definitely determinable benefits, the discretion must be exercised through an amendment to the plan adopted before the period to which the interest rate applies.