FREQUENTLY ASKED QUESTIONS ON THE DEFERRED RETIREMENT OPTION PROGRAM

(DROP)

LAKE WORTH FIREFIGHTERS' PENSION FUND

A. QUESTIONS ON DROP PROGRAMS IN GENERAL

1. WHAT DOES THE PHRASE "DROP" STAND FOR?

DROP is an acronym for deferred retirement option program or a delayed retirement option plan.

2. WHAT IS A DEFERRED RETIREMENT OPTION PROGRAM (DROP)?

A DROP Program is a form of retirement benefit that allows an employee to continue working while accumulating a savings account consisting of the benefits that would have been received had the employee actually retired. In other words, it is a chance to earn two incomes at the same time, with one of them being saved and invested without current tax liability. From a technical standpoint, a DROP program represents a method of providing for the deferred receipt of retirement benefits from a defined benefit plan.

3. WHERE AND WHEN DID DROP PLANS ORIGINATE?

DROP arrangements first started with several public safety plans in Louisiana during the mid-1970's to:

a. Encourage police and fire personnel who could retire early to continue working.

b. Allow a partial lump sum distribution option in the pension plan.

c. Provide the employer with a predictable turnover picture.

d. Replace a cost of living program that had become too costly to maintain.

DROP plans now exist in numerous state and local retirement systems. Originally popular with police and fire plans, they now exist for teachers and general public employees as well.

4. DOES A DROP PROGRAM REPRESENT A SEPARATE RETIREMENT PLAN?

A DROP program simply represents a distribution option within a traditional defined benefit pension plan. It is not a separate qualified retirement plan.

5. ARE ALL DROPS ALIKE?

No. There is no rigid structure that must be followed for DROP programs. The design of DROP programs vary greatly and can be crafted to meet the needs of the employees, the pension plan, and the plan sponsor.

6. IS A DROP PROGRAM AVAILABLE AS A BENEFIT FEATURE WITHIN THE LAKE WORTH FIREFIGHTERS' PENSION FUND?

Yes, a DROP Program first became available as a retirement option upon the Board's adoption of its DROP administrative rules. All DROP participants are advised that the Board reserves the right to revise the DROP program from time to time.

7. HOW WILL LAKE WORTH DROP PROGRAM WORK?

DROP is designed to allow you to accumulate a lump sum cash amount for retirement without affecting your normal monthly retirement benefit as of the date you became a DROP participant. Under DROP, you technically "retire," yet continue to work as an active Firefighter. For all non-pension benefits, you will continue to be treated as an active Firefighter. If you become disabled after participating in the DROP, you will not be entitled to receive a disability pension, since you are already retired.

Here's how it works. Once you reach the service requirements for a retirement, you are eligible to enroll in DROP. When you enroll in DROP, you agree to "lock-in" your service and benefit levels as of the effective date of your participation. From a service and benefit standpoint, it is as if you had retired on this date. You continue to work as an active Firefighter, though, and the Pension Fund credits your normal monthly retirement benefit (based on your service as of the date you entered DROP) into your DROP account. You also continue to earn your normal pay as an active Firefighter.

You can participate in DROP for a maximum of seven (7) years. During your participation in the DROP, your normal retirement benefit payments are added to your DROP account balance each month, which is invested on a tax deferred basis. When you leave the Fire Department, you choose how you want to receive your DROP account balance from available distribution methods.

B. <u>ELIGIBILITY AND PARTICIPATION QUESTIONS</u>

1. WHO IS ELIGIBLE TO PARTICIPATE IN DROP?

All members of the Firefighters Pension Plan (i.e., active members) are eligible to participate in the DROP, providing such members are eligible for normal or early service retirement and otherwise meet the requirements for DROP eligibility.

Eligibility to participate in the DROP is based on the completion of twenty (20) years of creditable service regardless of age, or the attainment of age fifty-five (55) with ten (10) years of creditable service.

2. **WHEN WILL PARTICIPATION IN THE DROP BEGIN?**

Entry into the DROP becomes effective upon the Board's approval of your DROP application. Once you enter into the DROP, you are retired for pension purposes. As a DROP participant, your monthly retirement income will be paid on the first day of each month into your DROP account.

3. **IN THE EVENT THAT AN ELIGIBLE MEMBER DECIDES TO PARTICIPATE IN THE DROP, WHAT MUST HE OR SHE DO?**

An eligible member may elect to participate in the DROP by complying with the election process and the administrative rules established by the Board of Trustees. Such requirements shall include, but shall not be limited to the following:

a. A written election to participate in the DROP.

b. Selection of DROP participation and retirement dates. Such retirement date shall be a binding application for retirement, establishing a deferred retirement date.

c. A written notification advising the member's employer of the date on which the DROP shall begin for the member, and

d. A properly completed DROP application for service retirement.

4. **CAN A PARTICIPANT LEAVE THE DEPARTMENT BEFORE THE END OF THE DROP PERIOD?**

Yes. A DROP participate can separate from service at any time before the end of the specified DROP period. Upon termination of employment, monthly pension payments will be paid to you, rather than being paid into your DROP account. You will also be entitled to the entire balance in your DROP account.

5. **WHILE I CONTINUE TO WORK DURING THE DROP PERIOD DO I HAVE ACCESS TO MY DROP ACCOUNT BEFORE THE END OF THE DROP PERIOD?**

No. In order to receive any payment from the DROP account, you must actually separate from service. It would violate both local and federal law to receive a distribution while still an active employee.

6. **DO I HAVE TO DECIDE AT THE TIME I ENROLL IN DROP HOW LONG I WILL PARTICIPATE AND KEEP WORKING FOR THE CITY?**

Yes. However, for purposes of preserving maximum flexibility, most individuals may find it advantageous to elect to participate for the maximum period of time even if they feel that their actual period of DROP participation may in all likelihood end at an earlier date. You can always terminate employment and retire prior to the end of your announced DROP participation period; however, once announced, you are not permitted to work beyond your originally stipulated DROP ending date even if such date fell short of the maximum period allowed for DROP participants.

C. <u>DROP PROGRAM EFFECTIVE DATE AND BEGINNING DATE</u>

1. **WHAT WAS THE EFFECTIVE DATE OF THE DROP PLAN?**

The Board of Trustees, under its rule making power conferred by City Code Section 16-75(e), adopted the DROP Plan on November 24, 1993.

2. **ONCE THE DROP PROGRAM WAS ADOPTED, WHEN WAS THE DROP PROGRAM AVAILABLE FOR INITIAL PARTICIPATION?**

The beginning date of each participant's DROP period shall be the first day of the month following approval of a member's DROP application.

D. <u>EMPLOYMENT STATUS QUESTIONS AND CONTRIBUTION REQUIREMENTS</u>

1. **ARE YOU COVERED BY SOCIAL SECURITY WHILE YOU PARTICIPATE IN DROP?**

Yes.

2. **IS A DROP PARTICIPANT CONSIDERED TO BE AN ACTIVE EMPLOYEE OR A RETIREE?**

A DROP participant shall be a retiree under the Pension Fund for accumulation of increased pension benefits, unless otherwise prescribed, but for purposes of employment with the City/County, the DROP participant shall be treated as any other active employee with respect to their ability to enjoy the availability of salary increases, promotions, employee benefits and programs related thereto.

3. **ARE YOUR CITY OF LAKE WORTH ACTIVE EMPLOYEE BENEFITS AFFECTED WHILE YOU ARE IN DROP?**

Generally speaking, no. You continue to accrue sick leave if you are eligible to do so now, and you continue to accrue vacation time. Any other time or day accrual for which you are presently eligible also continues. Your insurance coverage also continues uninterrupted and unchanged, at current active rates. In addition, you may continue to participate in the City's/County's Section 457 deferred compensation program. Since you are still a member of the Fire Department, the law provides that you remain eligible to vote in any Pension Fund elections. You are also eligible to serve on the Board of Trustees.

In contrast, as a DROP participant, you are considered retired and are no longer an active member of the Pension Fund. If you become disabled after participating in the DROP, you will not be entitled to receive a disability pension, since you are already retired.

4. **CAN YOU ENTER THE DROP AND LATER CHANGE YOUR MIND OR MUST A DROP PARTICIPANT ACTUALLY RETIRE AT THE END OF THE DROP PERIOD?**

The decision about when to retire as a Firefighter and whether or not to enter DROP is entirely your decision. Once made, the election to participate in the DROP carries with it a simultaneous election to retire that is irrevocable upon approval by the Board of Trustees. In essence, the DROP participant has contractually agreed to retire as a condition of entering the DROP program.

5. **WHAT WILL MY PENSION CONTRIBUTION REQUIREMENTS BE DURING MY PERIOD OF DROP PARTICIPATION?**

As an active employee participating in the Firefighters Pension Fund you are currently required to make employee contributions into the pension fund. Upon DROP participation, your employee pension contribution will cease, increasing your take-home pay.

E. <u>ACCUMULATION OF BENEFITS UNDER THE DROP PROGRAM</u>

1. HOW ARE MY RETIREMENT BENEFITS ACCUMULATED IN MY DROP ACCOUNT?

Once you decide to enroll into DROP your monthly retirement benefit is calculated based upon your service and benefit levels as of the date you entered the DROP. Your monthly retirement benefit is computed based on the two (2) highest of the last five (5) years of earnings immediately preceding participation in the DROP. Any additional service, benefit enhancements or raises occurring after entry into the DROP will not be utilized in the computation of your monthly retirement benefit.

Instead of having this monthly retirement benefit paid directly to you or deposited in your bank, it will be credited into your DROP account, where it will be invested, tax deferred, for as long as you participate in the DROP. Your retirement benefits will be paid into your DROP account on a monthly basis on the same schedule as used for retirees.

2. HOW IS INTEREST CALCULATED AND CREDITED TO MY DROP ACCOUNT?

Balances in your DROP account during your period of DROP participation will earn interest under one of two methods selected by the member: (i) at an annual fixed rate of interest or (ii) at the same rate earned by the Pension Fund. Upon entry into the DROP you will be required to make an irrevocable election as to one of these two methods.

The first option guarantees a fixed annual rate of interest, which is currently 1.5% below the Plan's actuarially assumed rate of return. Under the second option, DROP monies gain or lose interest at the same rate as the Pension Fund. Although a participant's DROP account may earn more than the fixed annual rate of interest, it is also possible that the DROP account will earn less than the fixed annual rate of interest, or even lose money based on the investment performance of the Fund!

F. PAYMENT OF BENEFITS UNDER THE DROP PROGRAM

1. HOW IS THE DROP ACCOUNT MONEY PAID OUT AND DISTRIBUTED?

When you terminate employment, your DROP account will be paid as you choose in one of the following ways:

a. Full Lump Sum - The participant receives the entire account less taxes.

b. Direct Rollover - The funds are paid directly to the custodian of an eligible retirement plan as defined in Section 402(c)(8)(B) of the Internal Revenue Code.

c. Partial Lump Sum - A combination of the first two, the proportion is up to you.

d. Monthly Distribution - The funds are paid out monthly, until the DROP account is depleted, over a number of years decided by you, subject to IRS restrictions.

e. Annual Distribution - The funds are paid out annually, until the DROP account is depleted, over a number of years decided by you, subject to IRS restrictions.

So long as you have not received a lump sum distribution or rollover of your DROP account balance, you will be permitted to periodically revise your distribution method. All remaining monies in your DROP account which have not been distributed or rolled over shall be invested based on the method that you have selected and earn (or possibly lose) interest accordingly.

2. HOW OFTEN CAN A PAYMENT CHANGE REQUEST BE SUBMITTED?

The DROP Plan does not set any specific limit on the number of times that payment instructions can be modified by a Participant. Nevertheless, the Board is vested with the authority to alter, amend or revise the DROP plan, if the Board determines that limitations become appropriate.

It is extremely important to note that adverse tax consequences may arise from a change in the distribution methodology. Under section 72 of the Internal Revenue Code, there is a ten percent (10%) early distribution penalty for payments received from a pension plan prior to age 59 ½ unless they are in the form of substantially equal payments, generally for life or life expectancy, or are in the form of a roll-over to another tax qualified plan or individual retirement account (IRA). Additionally, the early distribution

penalty will not apply if separation from service occurs in the year in which the employee turns 50. Changes in the methodology carry a chance of disqualifying all prior payments and subjecting the employee to the penalty.

3. **IF I SHOULD DIE AFTER I BEGIN RECEIVING PERIODIC DISTRIBUTIONS OF MY DROP ACCOUNT BALANCE BUT BEFORE THE FULL AMOUNT OF MY DROP ACCOUNT IS LIQUIDATED, CAN MY SPOUSE CHANGE THE DISTRIBUTION THEN IN EFFECT?**

   Yes. The selection of a distribution option can be changed by the DROP participant, a surviving spouse, or other beneficiary. For example, a spouse or surviving beneficiary might want to convert the existing distribution option to a Lump Sum distribution at the time of death. However, as discussed above, a change in the distribution methodology may result in adverse tax consequences. DROP participants and beneficiaries considering a change in the distribution methodology are advised to consult with a tax advisor.

4. **HOW IS THE ACCUMULATED VALUE OF THE RETIREMENT LEAVE ACCOUNT PAID OUT AND DISTRIBUTED?**

   When you terminate employment, the accumulated value of the Retirement Leave Account that is held within the Firefighters Pension Fund for the benefit of the DROP participant will be made available for distribution under the lump sum or rollover option.

5. **WHAT HAPPENS TO YOUR DROP ACCOUNT PROCEEDS AND THE ACCUMULATED VALUE OF THE RETIREMENT LEAVE ACCOUNT IN THE EVENT OF YOUR DEATH WHILE IN DROP?**

   If you die and are survived by a named beneficiary, that person will receive the DROP account. If there is not a named beneficiary, the DROP account will be paid to your estate.

6. **I UNDERSTAND THAT THE SPECIAL CALCULATIONS THAT ARE USED FOR DETERMINING PENSION BENEFITS IN THE EVENT OF LINE-OF-DUTY DEATH WILL NOT BE OPERATIVE ONCE I ELECT TO PARTICIPATE IN DROP. DOES THIS MEAN THAT MY BENEFICIARIES OR ESTATE WILL NOT BE ELIGIBLE TO COLLECT ANY DEATH BENEFIT PROGRAMS THAT MAY OTHERWISE BE AVAILABLE?**

   No. The prohibition against DROP participants from being eligible for line-of-duty death benefits only impacts the manner of calculating pension benefits. This prohibition does not extend to any other forms of death benefits that may be available to other active duty firefighters (i.e., employer life insurance, federal programs authorized under the Public Safety Officers' Benefits

Act, and death benefits available to firefighters under Florida Statute Sections 112.19 and 121.191, respectively).

7. **WHAT EFFECT DOES A DROP PLAN HAVE ON ELIGIBILITY FOR A DISABILITY PENSION?**

In order to be a participant in the DROP plan, and to have retirement benefits paid to the employee's account, the employee can no longer be an active member of the Fund. Since the employee is not an active member of the Fund, the employee is not eligible for a disability pension. If an employee becomes disabled during the DROP period, the employee will receive his or her normal retirement (at the lower rate) and will also receive the amount of money that has accrued in his or her DROP account.

8. **WHAT IS THE STATUS OF MY DROP ACCOUNT IN THE EVENT OF DIVORCE?**

DROP assets, like other forms of pension benefits, are considered marital property subject to division in a divorce proceeding. While DROP assets are not subject to distribution until a member terminates employment with the City/County, a court can determine that upon distribution, that a certain percentage of the DROP assets be awarded to a former spouse in the same manner as other retirement payments.

9. **WHAT TYPE OF ORDER IS USED BY THE COURT SYSTEM TO PLACE A LIEN AGAINST THE PROCEEDS OF THE DROP ACCOUNT IN THE EVENT OF A DIVORCE?**

Qualified Domestic Relations Orders (QDRO's) and Income Deduction Orders (IDO's) are two forms of court orders issued pursuant to divorce proceedings. A QDRO is a judgment, decree, or order by a court usually in the case of a divorce that relates to the provision of child support, alimony payments, or marital property rights to a spouse, child, or other dependent of a participant. Governmental plans, like the Firefighters Pension Fund, are not subject to QDRO's. Unlike governmental plans, QDRO's are specifically applicable to private pension plans under Internal Revenue Code Section 414(p)(2). Accordingly, the Firefighters Pension Fund does not recognize QDRO's for the assignment of any pension rights by a participant for distribution of a divorced spouse's interest. In lieu thereof, the State (under Section 61.1301, F.S.) has provided that IDO's for alimony and child support are mandatory court orders that the Pension Plan must follow. IDO's are taken from benefit checks or lump sum distributions to the spouse. The divorce laws can be quite complex. Therefore, you may wish to speak to legal counsel to discuss your personal circumstances.

G. TAX CIRCUMSTANCES UNDER DROP

1. THE DROP ORDINANCE STATES THAT THE FORM OF PAYMENT SELECTED BY THE DROP PARTICIPANT SHALL COMPLY WITH THE MINIMUM DISTRIBUTION REQUIREMENTS PER SECTION 401(a)(9) OF THE I.R.C., WHAT DOES THIS MEAN?

Section 401(a)(9) states that you must begin taking money out of a tax deferred retirement account (like an IRA or a DROP account) by April 1 of the year following the calendar year in which you turn 70-1/2 unless you are still working. If you are a participant in a qualified plan (like the Firefighters Pension Fund), and you are still working, you may postpone withdrawals until such time as you terminate employment. In addition to the beginning date requirement (age 70-1/2), Section 401(a)(9) requires that the distribution, if not taken as a lump sum, must be made over a specified period based upon life expectancy tables. Since the DROP participant must begin to liquidate the DROP account upon termination of employment, the beginning date requirements should not be an issue under the DROP program. However, all parties must be mindful to select a periodic distribution period that conforms to the requirement of 401(a)(9).

2. ARE AMOUNTS CREDITED TO DROP ACCOUNTS TAX DEFERRED?

Yes. Under Section 402(a) of the Internal Revenue Code amounts are taxable only if distributed. Thus, even though amounts are credited to the DROP account because they could have been paid as retirement benefits, the participant will not be subject to tax until DROP account balances are distributed to the DROP participant. No withholding taxes will be imposed during the period of DROP participation pursuant to Code Section 3401(a)(12)(A).

3. IF I DECIDE TO ROLLOVER MY DROP BENEFITS WHAT CAN I ROLL THEM INTO?

The law states that rollovers must be paid directly to the custodian of an eligible retirement plan as defined in Section 402(c)(8)(B) of the Internal Revenue Code (IRC). Eligible retirement plans include an individual retirement account (IRA) as described in Section 408(a), IRC; an individual retirement annuity [Section 408(b), IRC, except an endowment contract]; a qualified trust; and an annuity plan as described in Section 403(a), IRC. If you die, your spouse will only be eligible to rollover your DROP benefits into an individual retirement account or an individual retirement annuity as described in Section 402(c)(9), IRC.

4. HOW IS YOUR DROP DISTRIBUTION TAXED?

If you authorize the Pension Fund to transfer the lump sum value of your DROP account directly to an IRA or qualified retirement plan, there will be no immediate recognition of income for purposes of federal income taxation. You would pay taxes on these funds only as funds are received from your IRA or qualified retirement plan.

However, in the event that you do not choose a direct rollover of any portion of your DROP account that is an "eligible rollover distribution," the payment is taxed in the year you receive it. If you forego the rollover option and elect to receive the DROP account proceeds, the following rules would generally apply:

1. The distribution will be treated as a source of ordinary income to you (and taxed accordingly) in the year you receive it.

2. You will be subject to the 10% "early distribution" tax penalty rules if you are less than 50 years old when you separate from service.

3. You may be subject to a 15% "excess distribution" tax penalty if your total retirement proceeds (from the DROP account, any IRA's or qualified retirement plans) exceed the IRS maximum distribution amount for the year in which you receive the distribution.

This is our understanding of the current tax issues that you may wish to consider. We may not be correct. We are not allowed to give tax advice in any way. Keep in mind the **tax laws can change**, and they are complex. We **recommend and encourage** you to seek the advice of a tax professional to determine what is best for you and how you will be impacted.

5. WILL CREDITING AMOUNTS TO DROP AFFECT THE TAX-QUALIFIED STATUS OF THE FIRE PENSION?

No. However, in an abundance of caution, the Pension Plan submitted a request to the IRS for a review of the DROP program to ensure that the program will not jeopardize the tax-qualified status of the plan. Qualification of the Plan under 401(a) of the Internal Revenue Code would assure that DROP participants are not subject to "constructive receipt" of income under the plan with respect to DROP benefits prior to "actual distribution" of DROP benefits accrued under the Plan. Pursuant to 402(a), DROP participants, as Members of a "Qualified Plan" would not be subject to "constructive receipt" of income prior to "actual distribution." The IRS has issued a qualification letter for the Plan.

H. DROP DECISION CONSIDERATIONS

1. WHEN SHOULD I ENTER THE DROP?

This is a very personal decision. No one knows better than you when to begin taking retirement benefits. Once you enter the DROP, you cannot accumulate any more service credit in the Plan. A person who DROPs with more service will have a higher pension.

If the Plan benefits change after you DROP, those benefits may not be available to you. If you get a raise or a promotion after you enter the DROP, that salary increase will not count toward your pension. Once you DROP, you are retired under the Plan and your benefits are fixed.

2. WHAT ARE SOME ADVANTAGES OF DROPS?

A DROP program can be very advantageous to an employee who is interested in assembling a "nest egg" for themselves and their family and providing a "jump-start" into retirement. This "nest egg" can offer the employee the ability to start a business, purchase a home, travel, etc., upon retirement.

The DROP participant will see his required pension contribution reduced to 0% of pay. By eliminating such contributions, the employee's take-home pay will be increased.

The DROP program allows the employee to select an option that would effectively accelerate a portion of the retirement benefits that would otherwise have been received over an extended period of time. If the employee has reason to believe that his life expectancy will be less than average, the DROP could be viewed as a practical response to this outlook.

During the period of time that DROPs have become popular, the financial markets have done very well. As a result, many retirees have preferred to receive a lump sum payment so that such funds could be administered by professional money managers.

3. WHAT ARE SOME DISADVANTAGES OF DROPS?

One disadvantage of participating in a DROP plan is that the amount of monthly pension that an employee receives will be substantially lower than the amount that the employee would receive had the employee retired under a normal retirement calculation performed at the time of actual retirement.

Another disadvantage is that the decision to enter the DROP is irrevocable.

Sometimes employees change their minds about continuing to work, but once they have entered the DROP, they are not allowed to reverse the decision to retire. A retiree experiencing the birth of a child, a new marriage, divorce, or other significant life event, may have no choice but to retire at the end of the DROP period.

Lump sum payments may not be used judiciously, thereby placing financial pressures upon retirees at a point in their lives that they can ill afford to effectively respond to such pressures.

Lump sum payouts are subject to the mandatory 20% withholding requirements which would materially impact the funds available under the DROP. DROP participants may address this issue by electing a direct rollover to an eligible retirement plan or an IRA.

4. SHOULD I PARTICIPATE IN DROP?

One of the most important decisions you will have to make is whether you should join DROP or remain as an active contributor to the Fire Pension Fund. To assist in this decision, the Pension Office will provide upon request an estimate of the benefits you will receive if you elect to join DROP. Upon receipt of these estimates, you should meet with your accountant, CPA, financial planner, etc., to review your total financial situation, including pension and/or DROP benefits, personal investments, and Social Security benefits, to determine which choice will be the best decision for your future.

5. HOW CAN I GET MORE INFORMATION?

Entering the DROP is a big decision. Once made, it is FINAL. Before entering the DROP you are encouraged to contact the Pension Office with your questions. The DROP is a valuable benefit, but like anything, it does not meet everyone's needs in the same way. Before you DROP, be sure of your rights and make careful plans for your future. It would be wise to consult your own financial adviser concerning the choices that are most advantageous for your specific circumstances.