

LEOFF – Plan 2 DROP Issues



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BACKGROUND ABOUT THE PLAN

- Normal retirement age:
Age 53 with 5 years of service
- Early retirement age:
Age 50 with 20 years of service
- Normal retirement benefit:
Final average salary x years of service x 2%
- Early retirement benefit:
Actuarial reduction of 3% per year
(91% at age 50, 94% at age 51; 97% at 52)



BACKGROUND ABOUT THE PLAN

- **COLA:** On July 1 of every year following first full year of retirement, monthly benefit is adjusted based on the Consumer Price Index, up to a maximum of 3 percent.
- **Benefit limitation:** Benefit are not capped. According to the Member Handbook, “there is no percentage limitation on the size of your retirement benefit.”
- **Contribution rates:** 7.79% (member); 3.11% (state); 4.68% (employer rate excluding .19% administrative expense charge).



SUMMARY OF SAMPLE DROP PLAN PROPOSAL

- **DROP eligibility** – beginning at normal retirement age or early retirement age (subject to 3% per year early retirement reduction).
- **DROP earnings method** – can be based on a fixed rate (generally below the assumed rate of return); can be based on the Plan's actual rate of return (positive or negative); or can be self-directed similar to a 457 plan using a family of mutual funds selected by the Board.
- **DROP length** - 5 years, with declining DROP eligibility (encourages retention rather than retirement).
- **COLA treatment** - It is to be determined whether COLA is to be credited during DROP based on current COLA methodology. Delay of COLA until separation from service has a positive cost savings.
- **Member contributions** – cease upon entry into DROP ? (administrative charge of \$__ per month).



DROP OBJECTIVES AND GOALS

GOAL: PLAN FLEXIBILITY WITH NO ADVERSE ACTUARIAL IMPACT

- Plan flexibility - Allow members ability to save a lump sum DROP account balance;
- Cost neutrality - DROP details must be studied by the actuary, in light of plan assumptions;
- As a general rule, if the DROP encourages members to work beyond their normal retirement date, a DROP will lower the employer contribution rate. Conversely, the employer cost will increase if the DROP reduces the length of time worked after the plan's normal retirement date. *Society of Actuaries, Design & Actuarial Aspects of DROPs, p. 32*



ORDINARY DROP PROCEDURE (TRADITIONAL/FORWARD DROPS)

HOW DOES DROP WORK?

- Upon entering DROP you “retire” for pension purposes.
- Monthly pension benefit locks in based on current earnings and service.
- Pension benefit is paid into DROP account each month.
- Member must terminate employment at the end of the 5 year DROP period.
- DROP account earns or loses interest based upon formula.



DROP VARIATIONS

PLOPs (Partial Lump Sum Option Payouts)

- At the time of retirement, the member selects a percentage reduction to the monthly benefit and a corresponding partial lump sum payment;
- No prior election to join is necessary.

BACK DROPS (Retroactive DROPS)

- Similar to PLOP, but the monthly benefit is calculated as if the employee had entered the DROP when first eligible. Again, no need for prior election.
- The member receives a reduced monthly benefit plus a lump sum equal to the reduced benefit times the number of months since normal retirement eligibility.



DROP ELIGIBILITY

DROP ELIGIBILITY: Normal retirement at age 53 with 5 years of service, or Early retirement at age 50 with 20 years of service.

- In order to participate in the DROP, the member must submit a timely DROP application within 5 years of normal retirement date. The member loses one month of DROP eligibility for each month of delay.
- A member who does not submit a timely written DROP application will not be eligible to participate !
- Decision to enter DROP is irrevocable.



DROP LENGTH

DECLINING DROP PARTICIPATION (HOW LONG CAN I PARTICIPATE IN DROP?)

- Up to 60 months, depending on date of DROP entry;
- For every month that the member delays entry into the DROP, the member loses one month of DROP participation;
- Don't need to stay for the full DROP period (can always leave earlier if give advance notice to employer).



METHOD OF DROP INVESTMENT

- DROP account which follow Plan gains or losses will be invested along with other Pension assets.
- DROP account balances will gain or lose interest based on the actual performance of the Pension's investment managers. Most plans charge monthly fee to cover administrative costs.
- Involves market volatility (can lose money in a declining stock market).
- Guaranteeing a fixed rate of return introduces potential cost to the Plan.
- Self direction places a duty on the Board to select and monitor investment providers.



DROP ACCOUNT DISTRIBUTION

HOW IS DROP MONEY PAID OUT ?

- Single lump sum;
- Annual installments;
- Monthly installments;
- Combination of lump sum and period payments, or
- Rollover to another qualified plan, IRA or 457.

Can't touch DROP account until you separate from service.



DROP – TAX ISSUES

HOW ARE DROP DISTRIBUTIONS TAXED ?

- You can avoid current tax liability by rolling DROP balance over into another qualified plan, IRA or 457.
- Distributions from the DROP received prior to age 59 ½ are subject to a 10% penalty plus regular income tax unless:
 - (a) you separate from service on or after age 55, or
 - (b) you elect substantially equal distributions (annuitize payments).



DROP – TAX ISSUES

HOW ARE DROP DISTRIBUTIONS TAXED ?

- DROP is the deferred receipt of a defined benefit not a separate defined contribution plan;
- 415 rules apply to DROP calculations;
- DROP is a “definitely definable benefit” because it is the DC benefit with a defined interest methodology.



DROP – EMPLOYEE’S VIEW

ADVANTAGES OF DROP:

- Lump sum / “nest egg”
- Head-start on retirement
- Two incomes / accelerate your pension while still working
- Tax Deferred Growth of DROP earnings
- Tax deferral continues if rollover to an IRA
- Members no longer contribute 7.79% of earnings



DROP – EMPLOYEE’S VIEW

DISADVANTAGES OF DROP:

- Required to terminate employment in 5 years.
- If family circumstances change might not want to terminate employment – irrevocable decision.
- No disability or death benefits from the Plan since already retired. If either occurs, member is deemed retired on a service retirement.
- Don't get additional service or higher earnings – benefit is frozen when enter DROP.
- Lower monthly pension.
- If union negotiates a higher pension, assume enhancements would not be covered.
- Tax issues need to be properly navigated.



DROP – EMPLOYER’S VIEW

ADVANTAGES OF DROP:

- Retain experienced employees (depending on DROP design), U.S. Government Accountability Office Reports;
- Postpone recruitment and training of new employees;
- Aids personnel planning by requiring members to specify retirement date years in advance;
- Recruitment of new employees who want a DROP plan similar to other states;
- “DROP programs are popular with employees for a number of reasons. One major factor is that DROPs combine the flexibility of a DC plan with the security of a DB plan.” – Segal Public Sector Letter 2/2004.



DROP – EMPLOYER’S VIEW

DISADVANTAGES OF DROP:

- Cost neutrality is not automatically guaranteed (depends on plan experience in relation to plan assumptions and DROP design);
- Administrative and communication burdens;
- Risk of public misunderstanding DROP (important to educate public to avoid “double dipping” criticism);
- Can create shortage of experienced employees if not properly implemented.



DROP – IMPLEMENTATION

- “If designed properly, a DROP can produce net budget savings to public sector employers through reduced recruitment and training costs. However, if your plan considers a DROP, remember that, although it might help retain certain employees who are in short supply, it could also serve to encourage other employees nearing retirement age to stay longer.” NCPERS, Public Pensions & You, page 38.
- General Accounting Office reports that find that DROP helps with retention

ASK QUESTIONS!!!



**There is no such thing
As a Dumb Question**

SOURCES - REFERENCES

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- U.S. General Accounting Office, Report to the Subcommittee on Employer-Employee Relations, Older Workers - Demographic Trends Pose Challenges For Employers And Workers, GAO-02-85, 11/16/2001
- U.S. Government Accountability Office, Older Workers: Labor Can Help Employers and Employees Plan Better for the Future, GAO-06-80, 12/5/05