CITY OF KEY WEST GENERAL EMPLOYEES' RETIREMENT PLAN

FREQUENTLY ASKED QUESTIONS ON THE DEFERRED RETIREMENT OPTION PROGRAM

(DROP)

August 12, 2024

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-1980's to:

a. Encourage 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.

DROP plans now exist in Louisiana, Texas, Arkansas, Ohio, Oklahoma, and Florida on the state and local level as well as locally in Colorado and California. 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 KEY WEST EMPLOYEES' RETIREMENT FUND?

Yes, a DROP Program is found in Section 46-113 of the Code of the City of Key West.

7. HOW WILL THE 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 employee. For all non-pension benefits, you will continue to be treated as an active employee. **If you become disabled after participating in the DROP, you will <u>NOT</u> be entitled to receive a disability pension, since you are already retired.**

Here's how it works. Once you reach the service requirements for early or normal retirement (Normal retirement- either 20 years of credited service regardless of age or age 60 with 10 or more years of service. Early retirement- age 55 with 10 years of credited service), you are eligible to enroll. 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 employee, 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 employee. When an employee takes early retirement, the monthly benefit is reduced on an actuarial basis to account for the fact that you will be receiving benefits over a longer period of time.

Upon exercising the right to enter the DROP, your creditable service, compensation, and accrued pension benefit will become “locked-in”. The amount of your pension benefit will be determined based on the average of your highest consecutive five (5) years of service out of the ten (10) years immediately preceding participation in the DROP.

You can participate in DROP for a maximum of eight (8) years. The Plan requires that you must enter the DROP within the first 33 years of employment. It also provides that the number of years of active membership in the Plan and the DROP period combined may not exceed 33. Therefore, in order to get the full 8 years of DROP participation, you must enter the DROP prior to the end of your 25th year of service with the City. DROP payments are added to your account each month. An employee’s account in the DROP program earns or loses interest cased upon the actual earnings of the Plan for the preceding year. When you leave City employment, you choose how you want to receive your DROP account balance from available distribution methods.

B. ELIGIBILITY AND PARTICIPATION QUESTIONS

1. WHO IS ELIGIBLE TO PARTICIPATE IN DROP?

All members of the Employees Plan (i.e., active members) are eligible to participate in the DROP providing such members are eligible for early or normal retirement with the City.

2. WHAT ARE THE TIME LIMITS UNDER WHICH A MEMBER MUST ELECT TO PARTICIPATE IN DROP?

Election to participate may be made at any time following the date on which a member attains eligibility for early or normal retirement. An eligible member who wishes to participate in the DROP must provide notice to the City of his or her election to participate in the DROP.

3. HOW LONG CAN I PARTICIPATE IN THE DROP?

An eligible member may participate in the DROP for a maximum of eight (8) years. However, if a member enters the DROP after he has 25 years of service with the City, the DROP period ends when the member's years of service combined with participation in DROP totals 34 years. For example, if a member enters the DROP after 27 years of service with the City, he/she would only be eligible to participate in the DROP for 6 years. A member is required to terminate employment with the City and to terminate their DROP participation upon the completion of the DROP period.

4. 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 properly completed DROP application for service retirement.

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 City of the date on which the DROP shall begin for the member.

5. CAN I TERMINATE MY EMPLOYMENT BEFORE THE END OF THE DROP PERIOD?

Yes. A DROP participant can separate from service at any time before the end of the specified DROP period, with notice to the City. DROP payments would continue as monthly pension payments and the participant would be entitled to the entire balance in his/her DROP account.

6. **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.

7. **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, many 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. EMPLOYMENT STATUS QUESTIONS AND CONTRIBUTION REQUIREMENTS

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

Yes.

2. **IS THERE ANY SPECIAL MEMBERSHIP DESIGNATION IN THE PENSION FUND ONCE AN ACTIVE MEMBER BEGINS PARTICIPATION IN THE DROP?**

Yes. Upon participation in the DROP, the member shall be deemed a retiree of the Pension Fund.

3. 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, but for purposes of employment with the City, 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.

4. ARE YOUR 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 Section 457 deferred compensation program**. **Since you are still an employee of the City, the law provides that you remain eligible to vote in any Pension Fund elections.**

5. 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 an employee 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. Once acted upon by the Board of Trustees, the election to retire becomes irrevocable.

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

As an active employee participating in the General Employees Retirement Plan you are currently required to make pension contributions in the amount of 6% of salary as defined by the Plan. Upon DROP participation, your pension contribution requirements will be reduced to $0 and your monthly pension check will be paid into the DROP account until you terminate employment.

D. <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. 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. CAN I PURCHASE ADDITIONAL SERVICE CREDIT WHILE PARTICIPATING IN DROP?

No. Once participation in DROP begins, your retirement is final and you cannot add service credit, unless otherwise agreed to by the City through future Ordinance change made specifically applicable to DROP participants.

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

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, within 45 days following termination of employment:

a. Lump Sum - The participant receives the entire account balance 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.

2. WHAT HAPPENS TO YOUR DROP ACCOUNT AND ACCUMULATED LEAVE TIME IN THE EVENT OF YOUR DEATH WHILE IN DROP?

In the event of your death during the DROP period, all DROP and accumulated leave balances shall be payable to your designated beneficiary. If you have not designated your beneficiaries, the DROP and accumulated leave balances will be paid to your estate.

3. 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 your DROP 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.

4. 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, a court can determine that upon distribution, a certain percentage of the DROP assets be awarded to a former spouse in the same manner as other retirement payments.

F. TAX CIRCUMSTANCES UNDER DROP

1. 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).

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

The tax 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.

3. 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 may apply:

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

b. You will be subject to the 10% "early distribution" tax penalty rules if you are less than 55 years old.

c. 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.

G. DROP DECISION CONSIDERATIONS

1. 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 the required pension contribution reduced from a rate of 6% of pay to 0% of pay. By reducing 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.

2. 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 end of the DROP period. 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 enter the DROP, your retirement benefits are calculated under the Plan and are fixed as of the date of entry into the DROP.

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.

If a DROP participant becomes injured after entering the DROP, he or she will not be eligible to receive a disability pension, since DROP participants are already "retired".

3. 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 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.

4. 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. For more information, you may contact the Plan Administrator.