5 Things to Consider When Exiting DROP

The period from DROP-entry to DROP-exit typically lasts 4 years for most participants. Whether leaving DROP prematurely or staying the full duration, it's important to have a financial plan in place once you retire. This article covers five concepts to consider at the post-DROP period and the pitfalls to avoid. The goal is to make informed choices that maximize the benefits offered within the member's pension plan and within the tax code.

The first point to consider before exiting DROP relates to timing. When the DROP period ends (5 years typically), the employee must separate from service. It is important to time one's exit from the DROP after the member turns age 50. Retiring any sooner may compromise the employee's ability to access the DROP money without a 10% penalty. Per section 72(t)-10 of the internal revenue code, a firefighter can exit the DROP in the year he turns 50 and not be subject to a premature penalty. This section in the Code deals exclusively with sworn employees and is a calendar-based rule, not an age-based rule. For example, say a chief is scheduled to exit a 5- year DROP in August of this year and anticipates a DROP balance of $350,000. Let's assume he is presently age 49 but will turn 50 in December of this year. Per IRS guidelines, he can take a direct distribution from the DROP in any amount and not be subject to a 10% premature penalty. Now consider if he had chosen to exit DROP one year prior, in his fourth year of DROP. Under this circumstance, he would be age 48 at DROP- exit and have limited flexibility in accessing DROP without a penalty. In this way, entering DROP is an irrevocable decision, so the entry- date and exit-date need to coincide with the firefighter turning age 50.

In a similar vein, and a second point to consider, is to separate from service in the first quarter of the year. By timing one's retirement early in the year, the employee has the opportunity to maximize her retirement accounts by making another contribution for an additional year. An ideal way to accomplish this is by taking advantage of the catch-up provision within her 457(b) account. Most plans allow for a firefighter to roll unused sick time and vacation time to a 457 account or VEBA account. This tax deferral strategy is ideal for those who have accumulated sizeable unused balances. Rather than taking a check for these benefits, an employee has the opportunity to defer immediate taxation until a later date. Also, given the favorable distribution rules for 457 plans, a firefighter can request drawdowns right after separation from service occurs. For example, say a chief exits the DROP and has accumulated $18,500 in sick time and vacation time. He decides to have the city cut two checks: one to him for $5,000 to pay down debt, and another for $13,500 to his 457 provider. So long as he doesn't exceed federal guidelines on maximum contributions to the plan for the year, he can redirect the larger second check to his 457 account and take distributions on his terms.

A third point to consider at DROP-exit relates to health insurance. Whether an employee decides to stay with the city's insurance plan or enroll in another plan, all full-time firefighters qualify for a tax exclusion on part of their annual premium. The Pension Protection Act of 2006 allows eligible retired public safety officers to exclude $3,000 from gross income to pay for qualified health insurance premiums. Some pension plans will take care of this for the retiree by allowing for the first $3,000 of health insurance premiums as pre-tax payments and have remaining premiums paid as after-tax payments. It is important to be aware of this tax exclusion and also of your city's policy regarding insurance premium payments. Some systems pay health premiums exclusively after-tax, necessitating the employee to account for the exclusion on their own. Another way to satisfy the requirements of this exclusion is to have your 457(b) provider pay $3,000/yr. directly to the insurance provider. Say a firefighter exits DROP and decides to go

outside the city plan for health insurance and enrolls in coverage through United Healthcare. He has the option to instruct his 457(b) provider to cut a check for $3,000 each year made payable directly to his United Healthcare policy. So long as the distribution is coded correctly, it will not be deemed a taxable distribution.

A fourth point to consider prior to exiting DROP is estate planning. The interval between DROP-entry and DROP-exit is an ideal time for a firefighter to confirm the beneficiary(s) on his deferred comp 457(b) account, as well as review and update his will. This process should also include drafting an advance medical directive (living will), and powers of attorney. Life insurance policies need to be reviewed to confirm adequate coverage and competitive rates. This is particularly important if the member chose a more aggressive payout option (i.e. 10 year certain) when entering DROP. The estate planning process will go a long way toward ensuring a smooth transition of assets to the ones you care most about.

A final thing to consider at separation from service is cash flow needs. Different investment balances such as 457(b) money, DROP money, or Shareplan money have different rules associated with withdrawals. Developing a financial plan to avoid early withdrawal penalties and to provide adequate income throughout your life are the cornerstone issues facing firefighters at retirement. Additionally, earned income while collecting social security prior to full retirement age may result in reduced social security benefits.

There are a lot of moving parts when it comes to DROP and making a mistake can be costly. All of the different rules present potential pitfalls, so leveraging a financial professional who specializes in DROP is essential. With proper planning, exiting from DROP should be a smooth process and not involve withdrawal penalties on the DROP balance. Consider contacting us to discuss your specific situation so we can design a comprehensive, customized plan for you and your family.

Rick Palmer, Vice President, Investments, is a CERTIFIED FINANCIAL PLANNER™ professional and a recognized specialist on DROP at the DROP Consulting Group of Raymond James. He manages money for sworn employees and hosts educational seminars on DROP across the state of Florida. He can be reached at: 880 Carillon Pkwy-32E Saint Petersburg, FL 33716, (727) 567-8804 and www.gotdropusa.com.

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