5 Things to Consider When Entering DROP

Whether or not to enter the DROP is a unique decision and one which should be considered carefully. For some, the decision is a foregone conclusion due to personal circumstances and an attractive plan design. For others, the decision is less obvious and involves a more thorough review of the costs and benefits. This article covers the most important points to consider when a sworn employee has decided to enter the DROP. The goal is to avoid the common pitfalls in the DROP decision process and make informed choices that maximize the benefits offered within the pension plan and within the tax code.

The first and most fundamental point regarding DROP is that it is an irrevocable decision. The one consistent feature in all DROP plans is that once the paperwork is completed, the employee is considered “retired” for all practical purposes. As such, his length of service is suspended, his final average salary is calculated, and he no longer accrues pension credits. When the DROP period ends (5 years typically), the member must separate from service. It is important to recognize that during the period between DROP-entry and DROP-exit, most plans suspend a member’s contributions. So if a police officer had been contributing 7% (as required by the plan) to the pension prior to DROP-entry, his paycheck will effectively increase by 7% once he enters DROP. This may be an ideal time to increase 457 (deferred comp) contributions by a similar amount (7%), since the employee would not “feel” any difference in his take-home pay. This would likely lead to a higher 457 plan balance at the end of the DROP period and be an important resource in retirement. In short, a police officer has every incentive to increase 457 contributions at DROP-entry. Additionally, it would be an ideal time for a CERTIFIED FINANCIAL PLANNER™ professional to review the member’s 457 allocation and consider rebalancing the portfolio to lower risk.

A second point to consider before entering the DROP relates to timing. Ideally, one would enter the DROP after a pay-raise from a promotion, or perhaps right after a COLA (cost of living adjustment) is announced. This would maximize the member’s pension and therefore lead to a higher DROP balance at separation. 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 rules, a member can exit the DROP in the year she turns 50 and not be subject to a premature penalty. This section in the internal revenue 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 the DROP in November of this year and anticipates a DROP balance of $350,000. Let’s assume she is presently 49 years old, but will turn 50 in December of this year. Per IRS guidelines, if she takes a direct distribution for any amount in the DROP, she will not be subject to a 10% early-withdrawal penalty on the money. With proper planning, exiting from DROP should be a smooth process and not involve withdraw- al penalties on the DROP balance.

When entering DROP, another important decision a police officer must make is choosing a pension payout. The retirement benefit one chooses is a personal decision based on factors such as risk tolerance, investable assets, and whether one is single or married. The default retirement benefit in most plans is 10- year certain. This benefit is paid to you for life, but you or your beneficiary will receive at least 120 monthly benefit payments in any event. Keep in mind that the period certain begins once a police officer enters DROP, not at separation from service. So if a member is in DROP for 5 years, he has 5 years of period certain left when exiting DROP.

Interestingly, this type of default retirement benefit or “normal benefit”, is not the most conservative option and therefore might necessitate additional life insurance to mitigate expo- sure to premature death. Other optional forms of retirement benefit include joint & survivor payouts. While of equal actuarial value as the normal benefit, these optional forms vary in degree of risk. The most conservative option is 100% joint & survivor and guarantees that a spouse will receive an unreduced monthly annuity in the

Another thing to consider in choosing a retirement benefit relates to social security integration. Increasingly, this optional form of benefit is available in retirement plans. If you retire prior to the time at which social security benefits are payable, you may elect to receive a more level retirement income during your entire period of retirement by integrating your social security. Effectively, the city front-loads your pension by giving you a higher monthly amount and then reduces the pension once your social security payments begin. It is also a powerful way to turbo- charge your DROP, since it yields the highest monthly pension. However, many plans only allow social security integration if the member elects a single life annuity payout, a retirement income of a comparatively higher amount, but payable to you for your lifetime only (with no period-certain).

A fourth point to consider when entering DROP is that you will no longer be eligible for disability benefits under most pension plans. As such, if a police officer becomes disabled in the line of duty while in the DROP, he will not be eligible for benefits unless he has coverage in a private disability plan. Additionally, DROP participants are typically not eligible for pre-retirement death benefits either. Given this fact, it is important to review insurance coverage prior to entering DROP to minimize exposure.

A final point to keep in mind when entering the DROP is that most plans allow a police officer to roll unused sick time and vacation time to a 457 account. This tax deferral strategy is ideal for those who have accumulated sizeable balances. Rather than taking a check for these bene- fits, an employee has the opportunity to defer immediate taxation until a later date. Also, given the favorable distribution rules for 457 plans, a police officer can request drawdowns right after separation from service occurs. For example, say a chief enters 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 guide- lines 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.

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 pit- falls, so leveraging a financial professional is essential. Consider contacting me to discuss your specific situation and I will design a comprehensive, customized plan for you and your family.

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