MATHIS
PUBLIC SAFETY RETIREMENT

OPT TO DROP? UNDERSTANDING THE DEFERRED RETIREMENT OPTION PLAN

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Mathis Public Safety Retirement

One of the outstanding benefits available to many public employees—including teachers, first responders, public safety officers, and others—is the deferred retirement option plan (DROP). First adopted in the 1980s, DROPs have been developed as a way to provide additional flexibility around the retirement decision for the employee and also offer a way for employers to retain the services of experienced workers who have the desire and the capacity to remain on the job past normal retirement age.

This can be especially important in physically demanding careers such as law enforcement and firefighting, where employees often obtain the number of years of service required for full retirement pension benefits while still at a relatively young age. Because they are reaching retirement eligibility but may still have many years of productivity left, such individuals may be able to benefit from the DROP to extend their public service careers while still adding to the resources available to them for funding retirement or even launching a new career after leaving public service.

How Does the DROP Work?

In simplest terms, the DROP is a way for an employee who is technically retired, for the purposes of pension eligibility, to continue working and receiving income, along with contributions to a separate account that grows for as long as the employee participates in the DROP. Most DROPs require an employee to be eligible for full retirement benefits to participate. Upon entering the DROP, the employee's pension benefit is established and will not be increased. The employee will not receive pension benefits while in the DROP; instead they will continue working and receiving a regular paycheck.

The pension checks will be deposited into a separate, interest-bearing account. The pension checks continue for each year the employee is in the DROP. Most DROPs have a maximum participation period of five to seven years.

When the employee exits the DROP plan, they will begin receiving the pension benefits for which they are qualified. They will also receive the proceeds of the separate DROP account, plus interest or other gains accrued. Most plans offer several choices about how the DROP account is paid out. Common options include a lump sum, a rollover to a deferred compensation account or IRA.

DROP Basics

- Employee is qualified for full retirement pension.
- Employee effectively retires upon entering the DROP, but continues to work for up to five to seven years.
- Pension benefits are deposited into a separate interest bearing account during the DROP. The employee cannot access the separate account until they have exited the DROP.
- Employee continues to receive their regular salary while in the DROP.
- After exiting the DROP, employee begins receiving pension benefits.
- Employee also receives payout from the separate interest bearing account only after exiting from the DROP:
    - As a lump sum; or
    - As a rollover into a deferred compensation plan; or
    - As a rollover into an individual retirement account (IRA); or
    - (The above options depend on the provisions of the DROP plan)

How Are DROP Benefits Calculated?

The amount of money in an employee's DROP account is based upon the employee's years of service, their average annual salary during their regular employment career, the accrual rate for the plan (a percentage of average annual salary), and how many years they participate in the DROP. So for example (specifics will vary based on the provisions of the plan):

> A firefighter, age 55, has 25 years of service with the department has a $6,000/month pension. When that firefighter enters the DROP, the $6,000 enters the account every month until the firefighter exits the DROP. If you're interested in calculating your individual pension and DROP visit the **Public Safety Personnel Retirement System** (PSPRS State of Arizona). Reach out to our team with your questions.

Keep in mind that in addition to the amounts deposited, most DROP accounts guarantee a base rate of interest or other earnings for the account. So, in addition to the amounts shown above, the plan participants could also expect to receive the amount earned on the deposits during the term of the plan.

What Are the Requirements for DROP Participation?

Generally, most DROPs require that the employee is eligible for full retirement benefits. It's also important to note that for most DROPs, once you elect to enter the program, your choice is irrevocable. Your pension benefit will be determined, and though you will not begin receiving the benefit until you exit the DROP, the size of your benefit will not increase as a result of participating in the DROP. Instead, your receipt of pension benefits is delayed until you have finished the DROP and completely ceased working for your employer (this is where the "deferred" part of the name comes in).

Most DROPs do not require the employee to stay in the plan for the full term. If, for example, your state's DROP has a maximum participation period of five years, and you decide, three years into the plan, that you are ready to stop working for your employer and take full retirement, you may do so. Of course, this will affect the amount of money deposited into your DROP account.

General Characteristics of DROPs

- Require eligibility for full retirement to participate
- Have a maximum participation period of 5 to 7 years
- Do not require participation for the maximum period
- Are irrevocable, once initiated

What about Enrollment?

While individual plans vary, most DROPs specify a period of time upon reaching eligibility for full retirement when employees may elect to enroll.

Note that once you enter a DROP, you are “retired,” for the purposes of establishing your future pension benefits. Under the PSPRS plan, if you are injured during your DROP you may be eligible for a disability pension but you will need to exit the DROP. Upon exit you will receive any monies deposited into the separate, interest-bearing account up to that point. Plan conditions and requirements vary, so you should review the plan with your financial advisor before making your final decision about enrollment.

Who Should Consider DROP?

There are several important considerations for deciding whether the DROP is right for you. Everyone's situation is different, so it's often best to consult with a qualified financial service professional before making your decision about entering the DROP.

For example, it's important to know where you are on the pay scale for your career. If you are eligible for a promotion and pay increase soon, it might be more advantageous for you to wait to enter the DROP until you have established the higher salary and increased the calculation for your average annual pay. This would both qualify you for a higher pension and also increase the amount deposited into your DROP account during your participation period.

You should also take a careful look at your post-retirement goals and plans. If you plan to launch your own small business after leaving public employment, the lump-sum payout from the DROP could provide a handsome down payment on the expenses associated with opening a new enterprise. A lump sum could also come in handy for funding education expenses for a child or grandchild, for shedding debt before retirement, or for other important uses.

On the other hand, since the funds paid to you from your DROP account are counted as taxable income when received, that lump-sum payout could also put you in a higher tax bracket. **That could make a rollover to a deferred comp plan or IRA more attractive (this is the default for PSPRS DROP).**

There are also important non-financial considerations. Remember, once you enter the DROP, you are on a fixed timeline toward ceasing work for your employer. If the maximum participation period is five to seven years for your DROP, are you certain that you will be emotionally ready to leave work at the end of that time? If not, then it may not be the right time for you to start the DROP.

You should also think about how much control you want to have over the funds in your DROP account after you leave the program. If you want to exercise complete control over how the funds are invested, deferred comp (this is the default with PSPRS DROP) is probably the best option for you. You can direct how the funds are invested, and you can also structure withdrawals from the account in a way that is most advantageous for your individual needs. Remember, of course, that if your DROP funds are rolled over into an IRA, you will lose the early withdrawal of a public safety member and not be able to take payments until you reach 59 ½ years old.

Steps to Take if You Are Considering DROP

As you approach your full retirement eligibility date, there are some important matters you need to consider as you make your decision about whether to enter the DROP. Each person's situation is different, so in addition to the steps outlined below, there could be additional considerations.

1. Review your employer's requirements to apply for retirement. These may include:
    - Legible copy of birth certificate
    - Spouse's date of birth, if applicable
    - Legible copy of marriage license if you plan to apply for survivor payment options
    - Direct deposit information from your bank
    - Application for retiree health insurance benefits, if available
    - Other forms and documentation as required by your employer or pension plan
2. If your employer is a participant in the DROP, obtain a copy of the plan and study it closely, especially with regard to:
    - Enrollment window upon attaining retirement eligibility
    - Maximum participation period
    - Accrual rate
    - Any other requirements for enrollment, membership, or participation in the plan (including medical exams)

Get the Help You Need

Because entering the DROP is, in most cases, irrevocable, and especially given the important financial ramifications, it's important for most individuals to meet with a qualified, professional financial advisor prior to starting the plan. A fiduciary financial planner and advisor can learn about your unique circumstances and help you sort through the options available to you, taking into consideration the taxation and other implications of various distribution choices. They can also work with you to ensure that you are making the best choices for your goals and post-retirement plans.

Many important decisions surround retirement, and the DROP plan is one of the most central. The DROP that is right for you can provide significant additional financial security for your retirement. It's definitely worth it to take the extra time to make sure you're approaching the DROP in the way that is most advantageous for you.

SOURCES

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Mathis Public Safety Retirement

Our team at Mathis Public Safety Retirement has been helping clients make smart financial decisions since 1987. Our planning process, based on our core values of trust, transparency, and accountability, helps you look ahead with confidence. We are professional financial planners and that means we care about helping you achieve what is most important for you and your family.

All of us at Mathis Public Safety Retirement are committed to serving the community. We have partnered with Phoenix Firefighters Local 493, United Phoenix Firefighters Charities, and the Valley Women's Firefighter Society to help those in our community who are in need.

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