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8. Feasibility of DROPs for Certain Plans

8.1 ERISA Plans

It has been pointed out in several articles that adding a DROP feature to a plan covered by ERISA creates several issues that non-ERISA plans do not have to face:

- Carol V. Calhoun, Calhoun Law Group PC, "Deferred Retirement Option Plans," October 13, 1998 *Pension and Benefits Week*: "DROP plans adopted by private sector employers need to consider a host of additional legal issues under both the Code and ERISA."

- *AFSCME Collective Bargaining Reporter*, 1999 Number 3 (Revised April 2001): "Private employer plans are subject to much more complicated tax laws, and, therefore, it is unlikely that DROP plans will be offered to members working for private or nonprofit employers."

- June 1, 2000 Testimony of Sylvester Schieber and Kyle Brown of Watson Wyatt Worldwide to the ERISA Advisory Council: "DROP plans are not used in the private sector, possibly because of their expense."

- Norman L. Jones and Judith A. Kermans, Gabriel, Roeder, Smith & Company; *Plan Sponsor* April 1999, "Before you DROP: A guide for public plans." This article covers the point that private sector plans tend to have more lump-sum options already than do public plans. This would reduce the desire for DROPs in private sector plans.

We do not intend to provide a complete road map of how to design a DROP that foresees all of the potential "ERISA-only" issues that public plans are exempt from. However, here is a start.

Back loading: This is sometimes raised as an issue. The authors believe that back-loading issues end at NRA. This is based in part on the definition of an accrued benefit in IRC Section 411(a)(7)(A)(i) (defining the benefit as an annuity at NRD) and the nature of the back-loading rules in 411(b)(1)(A) -(C) (which tie the rule to NRD benefits). Therefore a DROP period that begins at normal retirement should have few issues. Some DROPs allow benefits at early retirement ages. In these cases, back loading should be considered. However, for the reasons discussed earlier, electing DROP at an early retirement age usually produces a DROP ratio of less than 100%, which implies a reduction in the rate of benefit accrual. Keep in mind that the interest, mortality and salary assumptions used to determine the DROP ratio might not be appropriate for testing back loading.

Providing an annuity form of benefit: ERISA requires that the automatic form of benefit be an annuity (either a J&S form for married participants or a life annuity for single participants). While this seems to be contrary to the idea of providing a lump sum, the DROP lump sum can be converted to an annuity using 417(e) rates with very little cost concern.

Timing of form of benefit election and spouse consent: In public plans there is usually no spousal consent requirement, and the form of benefit election can be made at the time of DROP or at the time of actual retirement with the normal form being credited to the DROP account in the meantime. Many public sector consultants recommend that the election be delayed until the time of benefit commencement. ERISA plans would likely require two elections. The first would be the DROP election at the beginning of the DROP election period. Second, would be the election of the form of annuity to be made at the point of the annuity commencement (while crediting the normal form[1] to the DROP account).

415 limits: It is more common to find Section 415 limits impacting benefits in ERISA plans. This is true partly because public plans have special limits and grandfather rules that do not exist for ERISA plans. The 415 limits do not present an obstacle for adding a DROP feature but complicate the calculations because of the presence of a partial lump sum.

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[1] By "normal form" we mean the form associated with the amount produced by the benefit formula. Often the normal form is a life annuity and the "automatic" form for a married participant is a reduced Joint & Survivor form.

Testing for nondiscrimination: To the extent that the DROP benefit is simply the actuarial equivalent of the NRD benefit, the non-discrimination result would appear to be the same as the pre-DROP plan. Limiting availability (through a window period) could present a coverage problem.

One area where there has been some interest is with collectively bargained plans. Many trades are not attracting young workers and need to find a way to retain older employees. These plans also have fewer non-discrimination issues than plans that are non-collectively bargained.

8.2 Canadian Plans

The laws in Canada can differ among 11 different jurisdictions (federal and ten provinces). In the area of post-retirement accruals, Quebec has the most relevant law to the discussion of DROPs. Below is a comparison to U.S. ERISA rules.

ERISA requires plans to provide employees who work beyond NRD with either: (1) a notice that payments will not begin until they terminate employment and a continuation of regular benefit accruals or (2) no notice of suspension of benefits but an actuarial increase in their benefit accrual until they actually terminate employment and benefits commence. For a long service employee the actuarial increase would provide the larger benefit (just as DROP ratios are often over 100%) but can be avoided by providing a prior notice.

In Quebec, traditional annuity accruals can stop at age 65; i.e., service and final average salary are frozen. Benefit payments are suspended until termination of employment. However, the benefit that would have been paid at age 65 is credited to a bookkeeping account (just as in most DROPs). Interest is credited at a fixed income rate set by legislation (similar to the 417(e) rate). At retirement the lump-sum account value is annuitized at the same legislated rate. It is paid in the same form as the base annuity at termination of employment.

In Canada, employees who terminate prior to age 55 must be offered the lump-sum option. Those who terminate after age 55 generally are not offered the lump sums. Therefore, it could be said that Canada has more DROP plans than the United States but generally requires payment in the form of an annuity.