



IRS issues section 415 guidance on governmental DROPs

The Internal Revenue Service (IRS) has issued a memorandum, which provides guidance to IRS employees when reviewing governmental defined benefit plans with deferred retirement option plan (DROP) features. The memorandum concludes that when a governmental plan credits the defined benefit amounts to a DROP, the defined benefit amounts are not subject to the defined contribution annual additions limit under Internal Revenue Code section 415. The memorandum further provides that additional contributions to the DROP are not considered annual additions if certain requirements are satisfied.

For 2015, the defined contribution limitation is \$53,000. The defined contribution limitation is the annual additions limit under Internal Revenue Code (“Code”) section 415. Annual additions are employer contributions (including employee pre-tax and Roth deferrals), reallocated forfeitures and employee post-tax contributions. The defined benefit limitation for 2015 is \$210,000 under Code section 415, which is generally the lesser of 100% of average compensation or \$160,000, as adjusted for cost-of-living increases since 2002.

Background

Governmental employers frequently adopt deferred retirement option plans (DROPs) as a means to retain employees who are eligible to retire. In a DROP, a defined benefit plan participant who would otherwise be entitled to retire and receive retirement payments under the defined benefit plan, continues to work and elects that benefit accruals under the plan are frozen with no additional benefit accruals. The retirement payments that the participant would have received are deposited into a DROP account in the retirement plan. The defined benefit plan may also allow additional employer or employee contributions to be made to the DROP account.

IRS guidance

Treatment of retirement payments

The IRS memorandum provides that IRS employees who review governmental defined benefit plans should not treat the retirement payments credited to the DROP as subject to the section 415 defined contribution annual additions limit. However, these payments are subject to the section 415 defined benefit limit.

Additional employer or employee contributions

Many DROPs provide that additional employer or employee contributions may be credited to the DROP. These additional contributions are not treated as annual additions, except in limited circumstances. The additional contributions are subject to the defined contribution annual additions limit only if all of the following three criteria are satisfied:

- The DROP consists of segregated accounts for each participant. If the plan language indicates it provides for segregated accounts, the plan representative must confirm under penalties of perjury how the plan is actually operated.
- Earnings on amounts in the DROP are based solely on actual investment earnings, i.e., the DROP does not provide for a fixed or guaranteed rate of return on funds in the DROP. DROP designs that are treated as having a fixed or guaranteed rate of return include plan designs where:
 - The rate of return is fixed at a pre-stated rate or at a 0% rate of return;
 - There is a maximum and/or minimum set for investment returns (e.g., a participant may choose from individual investments but is guaranteed a return of not less than a stated percentage); or

- A participant may choose from different investment options and the options include the two items described above.
- The DROP does not provide for cessation of earnings in the DROP account at any time. The plan language does not state that earnings will cease at the end of a certain period, known as the “DROP period.”

Next steps

The guidance provided in the IRS memorandum is complex. Plan sponsors of defined benefit governmental plans with DROP accounts, should contact the plan’s enrolled actuary if they have any questions regarding the information contained in this *Compliance Advisory*.

Compliance Advisory by Prudential Retirement

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Editor: Julie Koos (563) 585-6811

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