



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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MEMORANDUM FOR ALL EP EMPLOYEES

FROM: Robert S. Choi, Director /s/ *Robert S. Choi*
Employee Plans

SUBJECT: Applying Section 415 Limits to Governmental Defined Benefit Plans
with Deferred Retirement Option Plan Features

Purpose

This memorandum provides direction to Employee Plans (EP) employees reviewing governmental defined benefit (DB) plans with deferred retirement option plan (DROP) features, setting forth administrative guidelines for applying the benefit and contribution limits of § 415 of the Internal Revenue Code (Code) to such plans.

This directive is not a pronouncement of law and is not subject to use, citation, or reliance as such. Nothing in this directive shall affect the operation of any other provision of the Code, regulations, or guidance thereunder.

DROP Design

Under a typical DROP design, a DB plan participant who is eligible to retire and immediately receive retirement payments under the DB plan continues to work and makes an election under which the participant's benefit accruals under the DB plan are frozen (i.e., no additional service or compensation credits accrue). Pursuant to the election, the amounts that the participant would have received as a DB retirement payment had the participant in fact retired are credited to a DROP (for purposes of this directive, these amounts will be referred to as DB Benefit Amounts). The DROP may also provide for employee or employer contributions to be made to the DROP in addition to the DB Benefit Amounts credited to the DROP (Additional Contributions).

Administrative Guidelines

EP employees reviewing a governmental DB should not treat DB Benefit Amounts credited to a DROP as annual additions subject to the § 415(c) limitation applicable to defined contribution (DC) plans.

Accordingly, if you are reviewing a governmental DB plan that does not allow Additional Contributions to be made to the DROP, the plan will not be required to include § 415(c) limitation provisions for the DROP, and no further analysis with regard to the § 415(c) limitation for the DROP is required.

If you are reviewing a governmental DB that allows Additional Contributions to be made to the DROP, these Additional Contributions also will not be treated as annual additions subject to the § 415(c) limits except in limited circumstances as described below. If there are Additional Contributions, the § 415(c) annual addition limits will apply only with respect to the Additional Contributions and only if all of the following three criteria described below are satisfied. You should review the plan documents to determine if this is the case.

- (1) The DROP consists of segregated accounts for each participant;
- (2) 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; and
- (3) The DROP does not provide for cessation of the accrual of earnings in the DROP at any time.

With respect to the first criterion, if the plan's language indicates that it provides for segregated accounts for each participant, you should contact the plan's representative to receive written confirmation under penalties of perjury of how the plan is actually operated.

If the DROP does not meet any one of the above three criteria, the Additional Contributions will not be treated as annual additions subject to the § 415(c) limits.

The Appendix to this directive provides an explanation of the three criteria and examples of plan language to assist you in reviewing the plan documents.

If you have any questions regarding this directive, please contact Patrick Gutierrez at 202-317-8718.

cc: www.irs.gov

APPENDIX

Detailed Explanation of the Three Criteria Used for Determining Whether § 415(c) Limits Apply to Additional Contributions in a DROP

If a DROP provides for Additional Contributions, the following information is designed to facilitate the application of the three criteria listed in the directive.

I. Segregated accounts for each participant

For purposes of the directive, Additional Contributions will not be treated as annual additions subject to § 415(c) limits where the plan language does not indicate that it provides for segregated accounts for each participant or the plan's representative confirms that the plan is actually not operated with segregated accounts.

The following are examples of plan language providing for non-segregated accounts:

- *All benefits payable to a DROP participant shall be paid from the general assets of the Plan.*

- *All benefits payable under the DROP shall be paid only from the assets of the DROP, and the Employer shall have no duty or liability to furnish the DROP with any funds except to the extent required by applicable law.*
[NOTE - this does not provide for segregated accounts for each participant because the language groups the DROP accounts for all participants together.]

Pursuant to the directive, if the plan's language indicates that it provides for segregated accounts for each participant, the EP employee should contact the plan's representative to receive written confirmation under penalties of perjury of how the plan is actually operated. If the plan in fact does not operate as if benefits paid to a participant are paid only from the assets in the participant's DROP account, this first criterion is not met.

The following is an example of plan language indicating that it provides for segregated accounts:

- *All DROP benefits payable to a participant shall be paid only from the assets in the participant's DROP account.*

II. Actual investment earnings

If a DROP provides for a rate of return based on something other than actual investment earnings (such as a fixed or guaranteed rate), the DROP account is

not based “solely” upon contributions and earnings and the Additional Contributions will not be treated as annual additions subject to the § 415(c) limits.

For purposes of the directive, DROP designs that are treated as having a fixed or guaranteed rate of return include designs where:

- (a) the rate of return is fixed at a pre-stated rate, such as x% (this includes setting the earnings rate as a rate external to the plan (e.g., 10-year Treasury bills) or at a 0% rate of return (i.e., no earnings));
- (b) 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 x%); or
- (c) a participant may choose from different investment options and the choices include either (a) or (b).

The following are examples of plan language providing for fixed or guaranteed rates of return:

(1) Fixed rate on assets in DROP account:

A member's DROP account shall be credited each month with earnings based on an interest rate of X percent per annum compounded monthly.

If the plan language provides for a rate of return equal to the return on the assets of the entire DB plan, this shall be treated as a fixed or guaranteed rate and not actual investment earnings of the participant's DROP account.

(2) Maximum or minimum rate:

The DROP account shall be credited annually with earnings equal to the actual investment return on the assets in the participant's DROP account (as selected by the participant), but in no event more than X percent or less than Y percent.

(3) Interest rate determined by participant election:

- *Participant can choose interest at:*
 - (i) *a fixed rate of X percent,*
 - (ii) *the rate equal to the net investment return of Plan assets, or*
 - (iii) *the net investment return of the assets in the DROP account as selected by the DROP participant.*

- *Payment to the DROP shall be credited or debited with interest according to one of the following options chosen by the DROP participant:*
 - (i) *the DROP account is credited or debited with the same percentage as the net investment return of the Plan as a whole, or*
 - (ii) *the participant's DROP account is credited with the actual investment return on the mutual funds in the participant's DROP account (as selected by the participant).*

III. No cessation of the crediting of earnings in the DROP at any time

Most DROPs provide for the crediting of the DB Benefit Amounts into the DROP only over a defined time period, often five years (the DROP period).

For purposes of the directive, if crediting of investment earnings ceases at any time while assets remain in the DROP (for example after the DROP period), the DROP is not treated as providing for actual investment earnings and the Additional Contributions will not be treated as annual additions subject to the § 415(c) limits.

The following are examples of plan language providing for cessation of earnings:

- *Except as otherwise provided in the section above (providing that interest ceases at end of DROP period), the DROP account shall be credited with...*
- *If an employee does not terminate employment at the end of participation in the DROP, interest shall no longer be credited to the DROP account.*