

November 28, 2023

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**VIA ELECTRONIC MAIL**

Board of Trustees  
City of Sunrise Police Officers' Retirement Plan

**RE: Federal Tax Law Considerations for DROP Distributions**

Dear Board of Trustees:

Please allow this letter to respond to the questions brought to us by Richelle Levy, Lorium Law, regarding the federal law considerations for a lump sum distribution from the Deferred Retirement Option Program ("DROP") under the City of Sunrise Police Officers' Retirement Plan ("Plan").

Generally, federal tax law raises two questions with regard to such distributions:

- Has there been a distributable event under the terms of the applicable Plan document and in compliance with federal tax law (i.e., a bona fide separation from service or permissible in-service distribution)?
- How must the benefits paid under the each of the Plans be taxed and reported on Form 1099-R (i.e., does the 10% early distribution penalty apply, and what is the impact when there is a rollover)?

**A. Distributable Events under Qualified Retirement Plans**

A qualified retirement plan (such as the Plan) cannot make distributions to a participant unless there has been a permissible distributable event. For qualified plans, federal law allows distributions to begin upon bona fide separation from service (termination of employment), attainment of normal retirement age, or attainment of the permitted in-service distribution age. Treas. Reg. § 1.401(a)-1(b)(1)(i). The terms of the Plan must set forth the provisions for permitted distributions.

The IRS requires a separation from service to be "bona fide"—the employer/employee relationship must be completely severed. To be "bona fide," there cannot be any understanding or agreement (formal or informal) that the employee will be re-hired by the employer. However, if the employee has attained normal retirement age, the plan can be drafted to permit "in-service"

distributions (*i.e.*, without a bona fide separation from service). Under Proposed Regulations, the IRS has established certain "safe-harbor" normal retirement ages (including safe-harbors for public safety employees) that are permissible for purposes of allowing in-service distributions. Finally, under Internal Revenue Code ("Code") Section 401(a)(36), a qualified plan may provide for in-service distribution to participants upon attainment of age 59 ½.

We have not been asked to review the Plan's terms with respect to distributable events. Thus, for purposes of this letter, we have assumed the Plan's terms for distribution are permissible under federal law.

## **B. Early Distribution Penalty and Exceptions**

Code Section 72(t)(1) imposes a 10% penalty on early distributions from qualified retirement plans, unless an exception applies. With respect to distributions from the Plan, the most relevant exceptions to the 10% penalty include the following:

- Distributions made on or after the date a member attains age 59½ (Code Section 72(t)(2)(A)(i));
- Distributions made as part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and beneficiary, beginning after the date the member has separated from service (Code Sections 72(t)(2)(A)(iv) and (t)(3)(B)); and
- Distributions made to an employee after separation from service in or after the year the employee reaches age 55. For a distribution to a qualified public safety employee from a governmental plan, the distribution must be made after the employee's separation from service in or after the year the employee reaches age 50 or in or after the year in which the employee has 25 or more years of service under the plan. (Code Sections 72(t)(2)(A)(v) and (t)(10)) (we refer to this exception as the "Code Section 72(t)(10) exception").

The attainment of "normal retirement age" under a plan, in and of itself, does not operate as an exception to the 10% early distribution penalty.

- **Note:** There are other exceptions to the 10% early distribution penalty other than those listed above (for example, disability, death, payments under a qualified domestic relations order). The exemptions listed above are the most common ones that would be applicable to a distribution from the Plan.
- a. Attainment of age 55/50 or 25 Years of Service with Separation from Service Exception (Code Section 72(t)(10) Exception)**

With respect to the Code Section 72(t)(10) exception, the member's separation from service must occur during or after the calendar year in which the member reaches age 55/50 or 25 years

of service. See IRS Notice 2007-7, Q&A-7; IRS Notice 87-13, Q&A-20 (“A distribution to an employee from a qualified plan will be treated as within section 72(t)(2)(A)(v) if (i) it is made after the employee has separated from service for the employer maintaining the plan and (ii) such separation from service occurred during or after the calendar year in which the employee attained age 55.”) Additionally, IRS Publication 575 provides an example explaining that a member cannot “age into” the exception:

Separation from service. In order to meet the requirements for the first exception in the list above, you must have separated from service in or after the year in which you reach age 55 (or age 50 for qualified public safety employees). You can’t separate from service before that year, wait until you are age 55 (or age 50 for qualified public safety employees), and take a distribution.

Example. George separated from service from his employer at age 49. In the year he reached age 55, he took a distribution from his retirement plan. Because he separated from service before he reached age 55, he didn’t meet the requirements for the exception for a distribution made from a qualified retirement plan (other than an IRA) after separating from service in or after reaching age 55 (age 50 for qualified public safety employees).

IRS Publication 575, p. 36 (emphasis added).

IRS Notice 2007-7 provides additional guidance on the application of this exception. A qualified public safety employee (i) must have received the distribution from a governmental plan after separating from service with the employer maintaining the plan, and (ii) the separation from service must have occurred during or after the calendar year in which the qualified public safety employee attained age 50. Q&A-7.

Additionally, IRS Notice 2007-7 provides as follows:

Q-9. Does the exception to the 10% additional tax under § 72(t)(10) apply if the qualified public safety employee rolls over distributions from a governmental defined benefit plan into an IRA or a defined contribution plan and subsequently takes an early distribution from the IRA or defined contribution plan?

A-9. No. The exception to the 10% additional tax under § 72(t)(10) applies only to amounts distributed from a governmental defined benefit plan and does not apply to distributions from a defined contribution plan or an individual retirement plan.

Importantly, at the time IRS Notice 2007-7 was issued, Code Section 72(t)(10) required that the distribution be from a governmental defined benefit plan; this provision was amended in 2015 to simply require the distribution to be from a governmental plan, allowing it to apply to distributions from governmental defined contribution plans as well as defined benefit plans.

**b. Substantially Equal Periodic Payments Exception**

This exception requires that the payments be a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary, and that the series of payments begins after the employee separates from service. Code Sections 72(t)(2)(A)(iv) and 72(t)(3)(B). The lump sum payments from the DROP would not meet this exception.

**c. Additional Considerations for Rollover of Distribution**

If a member rolls over the DROP lump sum distribution to an IRA or eligible retirement plan, the 10% penalty will not apply at the time of the rollover (because it is treated as a rollover as opposed to an actual distribution to the member). In the case of a direct rollover, the Plan would directly transfer the lump sum to the IRA or eligible retirement plan as directed by the member. On the Form 1099-R, the Plan would report the distribution using code G in Box 7, indicating a direct rollover and that the distribution is not subject to the 10% early distribution penalty.

If the member does not choose a direct rollover and the DROP lump sum payment is distributed directly to the member, the Plan would be required to withhold 20% from the taxable portion of the distribution for federal tax withholding. In this situation, the member would have the option of doing an indirect rollover within 60 days of receipt of the distribution, to an IRA or eligible retirement plan. On the Form 1099-R, the Plan would report the distribution to the member based upon application of the exceptions to the 10% penalty discussed above (code G would not be used in Box 7, instead code 2 or 7 would be used based on the member's age).

Once a member has rolled over a distribution, the distribution generally will be subject to the distribution provisions of the receiving plan. Any distributions from the receiving plan will be reported on Form 1099-R by that plan; thus, while below we have provided our guidance on how we think the exceptions to the 10% penalty would apply to the subsequent distribution, ultimately the distributing plan will make its own determination.

Under Revenue Ruling 2004-12, if an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan, distributions of those amounts are not subject to the restrictions on permissible timing that apply, under the applicable requirements of the Code, to distributions of other amounts from the plan. Accordingly, the plan may permit the distribution of amounts attributable to rollover contributions at any time pursuant to an individual's request (however, a plan is not required to permit such distributions). Revenue Ruling 2004-12 further states:

Thus, for example, if the receiving plan is a money purchase pension plan and the plan separately accounts for amounts attributable to rollover contributions, a plan provision permitting the in-service distribution of those amounts will not cause the plan to fail to satisfy the requirements of § 1.401-1(b)(1)(i). Similarly, if the

receiving plan is a § 457 eligible governmental plan or a tax-sheltered annuity described in § 403(b)(7) or (11), amounts attributable to rollovers that are maintained in separate accounts are permitted to be distributed at any time even though distribution of other amounts under the plan or contract is restricted pursuant to § 457(d)(1)(A) and § 403(b)(7) or (11), respectively.

However, a distribution of amounts attributable to a rollover contribution is subject to the survivor annuity requirements of §§ 401(a)(11) and 417, the minimum distribution requirements of § 401(a)(9), and the additional income tax on premature distributions under § 72(t), as applicable to the receiving plan. Thus, for example, if a distribution from an IRA is rolled over into a plan described in § 401(a), any distribution from the § 401(a) plan of amounts attributable to the rollover would be subject to the exceptions from the § 72(t) tax that apply to § 401(a) plans and not the exceptions that apply to IRAs.

Emphasis added.

Based on this guidance and IRS Notice 2007-7, the member would need to confirm the terms of the plan to which they would be rolling over (for instance, whether the plan accepts and separately accounts for rollovers). The application of the 10% early distribution will generally be determined based on the circumstances for the subsequent distribution from the receiving plan. In considering this application:

- It is clear that, if a member does a rollover of a DROP lump sum payment from the Plan to an IRA, the Code Section 72(t)(10) exception would no longer apply to a subsequent distribution from the IRA.
- Further, we think that if a member rolls over a DROP lump sum payment from the Plan to a non-governmental plan (for example, a non-governmental 401(k) plan), it is likely that the Code Section 72(t)(10) exception would no longer apply to a subsequent distribution from the 401(k) plan. This is because the Code Section 72(t)(10) exception only applies to distributions received from a governmental plan. *See* Code Section 72(t)(10); IRS Notice 2007-7, Q&A-7.
- We do not think that there is any direct guidance on whether the Code Section 72(t)(10) exception would continue to apply if a member rolls over a DROP lump sum payment from the Plan to a governmental 457(b) plan. While the 10% early distribution penalty does not apply to distributions from 457(b) plans, the IRS has been clear that when a 457(b) plan receives a rollover from a qualified retirement plan that such amounts must be separately accounted for, and that the 10% early distribution penalty continues to apply. Ultimately, we think that there is a reasonable argument that the subsequent distribution of the rollover is being made from a governmental plan and, thus, the Code Section 72(t)(10) exception should still apply, although the distributing plan will make its own determination on this point.

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- Finally, we think that if a member rolls over a lump sum payment from the Plan to another qualified governmental plan (either defined benefit or defined contribution), there is a persuasive argument that the Code Section 72(t)(10) exception should still apply to a subsequent distribution, although the distributing plan will make its own determination on this point.

Of course, if you have any questions or comments regarding this information, or if you want to discuss these issues further, please do not hesitate to let us know.

Very truly yours,

ICE MILLER LLP

A handwritten signature in black ink, appearing to read "Robert Gauss", written over a horizontal line.

Robert Gauss

A handwritten signature in black ink, appearing to read "Lisa Erb Harrison", written over a horizontal line.

Lisa Erb Harrison

Cc: Richelle Levy