ATTACHMENT # 3

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May 6, 2010

Jay L. Smith, Chairman
Orlando Police Pension Plan
400 S. Orange Avenue
4th Floor
Orlando, FL 32802-4990

Re: Orlando Police Pension Plan - Plan-to-Plan Transfers
Our File No. 040007

Dear Jay:

This is in response to your request for a legal opinion concerning the tax impact of certain plan-to-plan transfer issues arising out of the application of the Pension Protection Act of 2006 (PPA). Specifically, you asked several questions, which are as follows:

1. If a member separates from the City in the year in which the member attains age 50, is there an early distribution penalty relating to DROP payments?

   This question is answered in the negative. Section 828 of the PPA lowered the age for public safety officers from 55 to 50. If an Orlando police pension participant turns 50 at any time during the calendar year in which he or she separates from service, the 10% early distribution penalty under Section 72(t) of the Internal Revenue Code (IRC or the Code) will not apply. Separation in the year means that member may leave service and take a distribution on January 1 of a year as long as the member will have his or her 50th birthday in that same calendar year, even if it were to occur as late of December 31st of that same year. The key is the date of distribution. In other words, the penalty applies to the member's age at time of distribution. A distribution from a member's DROP account will not be subject to the IRC §72(t) early withdrawal penalty, assuming that the member:

   - is a "qualified public safety employee", as defined in IRC §72(t)(10)(b),

and

- has separated from service in a year in which he turned age 50 or older.

The lower age for qualified public safety employees is only available if the distribution is from a governmental defined benefit plan. Distributions from other types of plans are not included in the IRC §72(t)(10) exception. Considering that DROP plans are generally considered part of an overall defined benefit plan, a distribution from a DROP account would generally not be subject to the 10% early withdrawal penalty as long as it meets the above criteria. The IRS guidance states as follows :

Question 7 in Internal Revenue Service Notice 2007-7 provides as follows:

Q-7. How does a qualified public safety employee qualify for the exception to the 10% additional tax under § 72(t)(10)?

A-7. In order to qualify for the exception to the 10% additional tax under § 72(t)(10), a qualified public safety employee (i) must have received the distribution from a governmental defined benefit 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. For example, a qualified public safety employee who separated from service on June 30, 2006, and attained age 50 on December 12, 2006, is eligible for the exception under § 72(t)(10) with respect to distributions made after August 17, 2006.

2. Are there any IRS regulations concerning investment return in a DROP account?

According to IRS Letter Ruling 200721022 (Feb. 26, 2007), a DROP account is not considered a separate defined contribution plan when "the amounts placed in an account for a participant do not receive their share of the actual earnings and losses of the plan." Such a DROP account is not an "individual account" within the meaning of Section 414(i), and therefore is not considered a separate defined contribution plan. Because it is not considered a separate defined contribution plan, DROP is automatically considered part of the overall defined benefit plan, as defined in I.R.C. §414(j).

This carved-out exception from the definition of "defined contribution" applies to DROP accounts which do not earn their share of the actual earnings and losses of the underlying plan. This has been confirmed in IRS letter rulings. If a DROP account is credited with no

interest, or interest at a stated rate, the DROP account would be considered part of the employer's overall defined benefit plan. The IRS has not ruled whether a similar exception from the definition of "defined contribution" exists for DROP accounts which instead receive their share of the earnings and losses of the underlying plan. Some commentators have written that if a DROP account is credited actual earnings or losses, either the plan as a whole or the individually directed accounts could be treated as a defined contribution plan and would be subject to the limitations on contributions set forth in I.R.C. §415(c) for defined contribution plans. *See* Governmental Plans Answer Book, Second Edition Aspen Publishers (2007). However, since a DROP account cannot receive forfeitures, and the receipt of forfeitures is included in the conjunctive in I.R.C. §414(i), the IRS could rule that a DROP which receives earnings and losses is still a part of the overall defined benefit plan. At this point, however, we have no IRS guidance on that matter.

At this time as long as the member has no access to DROP assets while it is in the possession of the Orlando Police Pension Plan, it is not taxable. Once the benefit is paid to the member, it is taxable as ordinary income. If paid prior to the year in which the member reaches age 50, the early distribution penalty applies along with the regular income taxes.

3. If a member rolls DROP money into a 457 plan, what are the tax implications of a distribution before age 59 ½?

The PPA was specifically amended to permit 457 plans to accept or make rollovers to and from "qualified plans." A qualified plan is a benefit plan which meets certain IRC requirements and therefore "qualifies" for favorable tax status of certain types of distributions. The Orlando Police Pension Plan is a "qualified plan." Normally, 457 plan distributions are not subject to the early distribution penalty. If the payment of the rolled over money is from a 457 plan, the same rules must apply as if the distribution was from the pension plan. In other words, one cannot do a DROP rollover to a 457 plan and then try to avoid the early distribution penalty otherwise applicable to the pension plan. If the distribution is prior to the year in which the member attained age 50, the 457 plan assets representing the rolled over amount will be subject to the early distribution penalty. The restrictions placed on a distribution from a §457 plan depend largely on the source of the funds used to make the distribution. If the distribution is made using traditional §457(b) funds, the restrictions found in I.R.C. §457(d) apply. If the distribution from the §457 plan is made using funds rolled over from certain other kinds of plans, the restrictions and penalties found in I.R.C. §72(t) would apply.

All money rolled over into a §457 plan (including money rolled over from DROP accounts) must be separately accounted for within the §457 plan. The reason for the separate

accounting requirement is that, under I.R.C. §72(t)(9), the amounts distributed from a §457 plan will be subject to the 10% penalty on early withdrawals to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Whether the distribution is subject to the 10% penalty for early withdrawals depends on the source of the rollover funds. If the rollover funds would have been subject to the 10% penalty under the plan they were rolled over from, a distribution from such funds would still be subject to the penalty, even though it is made from the §457 plan.

In other words, distributions from the §457 plan made with rolled over DROP funds will be given the same tax treatment they would have been given had they had remained in the participant's DROP account. The following except is taken from IRS Notice 2009-68:

If your payment is from a governmental section 457(b) plan :

If the Plan is a governmental section 457(b) plan, the same rules described elsewhere in this notice generally apply, allowing you to roll over the payment to an IRA or an employer plan that accepts rollovers. One difference is that, if you do not do a rollover, you will not have to pay the 10% additional income tax on early distributions from the Plan even if you are under age 59 1/2 (unless the payment is from a separate account holding rollover contributions that were made to the Plan from a tax-qualified plan, a section 403(b) plan, or an IRA). However, if you do a rollover to an IRA or to an employer plan that is not a governmental section 457(b) plan, a later distribution made before age 59 1/2 will be subject to the 10% additional income tax on early distributions (unless an exception applies).

I hope this answers your questions.

Sincerely,

STUART A. KAUFMAN

SAK:ldm
cc: Christopher P. McCullion, Executive Director

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