



**NATIONAL COUNCIL
ON TEACHER
RETIREMENT**

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Via Courier and Internet (Notice.Comments@irsounsel.treas.gov)

Internal Revenue Service
Courier's Desk
Internal Revenue Building
1111 Constitution Avenue, NW
Washington, DC

RE: Comments on IRS Notice 2002-43

Ladies and Gentlemen:

The National Council on Teacher Retirement (NCTR) appreciates the opportunity to submit comments to the Treasury Department ("Treasury") and the Internal Revenue Service ("Service") on phased retirement programs under qualified defined benefit plans. The comments are the result of principles (below) drafted by a review group, the members of which included NCTR's Executive and Legislative Committees. NCTR comprises 79 state, local, university, and territorial retirement systems that serve teachers and other public employees.

These comments concentrate on how phased retirement can advance the complementary interests of employees and employers in the state and local government ("SLG") sector. They are limited to the retirement systems of SLGs. Accordingly, they do not address the nondiscrimination testing and compliance under Code Section 401(a)(4), joint and survivor rules under Code Sections 401(a)(11) and 417, or Code Section 411, all of which are generally inapplicable to such retirement systems. They are also limited to phased retirement programs only and do not discuss return to work programs (in which employers hire retired employees under certain conditions).

NCTR members are collectively and individually interested in phased retirement. As a group, NCTR members adopted resolutions in both 2000 and 2001 expressing their views on the issue. In addition, an individual NCTR member, the Wisconsin Department of Employee Trust Funds (DETF), released a study on the issue in 2001. DETF laid out the rationale for addressing the phased retirement programs in Wisconsin and proposed

changes needed to implement such programs. DETF's findings are of use to SLGs and retirement systems in other states interested in the issue.

This letter begins with a set of principles on phased retirement. It then sets out the following:

- Background
 - Purpose of State and Local Government (SLG) Retirement Plans
 - Description of Phased Retirement
 - Structure of SLG Retirement Systems
- Impediments to Phased Retirement
- Considerations about Phased Retirement
 - Need for Voluntary Programs Affording Maximum Flexibility
 - In-Service Distributions Only After Individual is Eligible for a Retirement Benefit or Allowance
 - No Guidance Needed on Return to Work Issue
- Response to Questions Posed in Notice 2002-43
- Final Thoughts

PRINCIPLES FOR PHASED RETIREMENT

NCTR's review group reached consensus on the following principles.

1. Good retirement planning for some individuals means avoiding an abrupt termination of work and, instead, gradually transitioning into a retirement that meets their social and economic needs. These programs are called "phased retirement" or "transitional retirement." They are work arrangements that permit an individual to move from his/her career position to a position of reduced hours, lower compensation, or reduced physical or mental stress before full retirement.

2. Every retirement system is different in design. Thus, IRS activity in the area of phased retirement should allow, but not mandate, retirement systems to have such programs.
3. Any IRS activity in the area of phased retirement must recognize that retirement systems have different funding methods and varying levels of funding. Accordingly, IRS should not adopt any policy that would require retirement systems to assume additional funding obligations.
4. IRS should clarify that the definition of such terms as normal retirement age, early retirement age, minimum retirement age, and final or highest average compensation (or whatever term is used in a particular jurisdiction) should be whatever appears in the applicable state or local laws, regulations, case law, and policies governing the retirement system. Such clarification serves to recognize that state and local governments have different ways of defining these terms.
5. In-service distributions should be permitted only after an individual becomes eligible for a retirement benefit or allowance.
6. Any phased retirement program should allow state and local governments to protect the value of a participant's retirement benefit during a "bridge job." A "bridge job" is a position that offers reduced hours, lower compensation, or reduced physical or mental stress than career employment and covers the period between career employment and full-time retirement. It is also called a transitional job.

These principles underlie NCTR's response to the request for comments.

BACKGROUND

Purpose of State and Local Government Retirement Plans

SLGs offer retirement plans, generally defined benefit plans, to provide their employees with income during their retirement years. The plans provide a benefit tied to an employee's earnings and length of service, as described below. The plans help employers to attract and retain skilled workers.

Up until recently, the retirement model in the SLG sector has consisted of a full-time job followed by full-time retirement, with no transition between the two. As stated in the Notice, both employers and employees are now expressing interest in encouraging older, more experienced workers to stay in the workforce. IRS points out that phased retirement programs provide a smoother transition from full-time employment to

retirement. They also help employers to retain the services of experienced individuals. The intersecting interests of these employees and employers open the discussion for phased retirement as an additional approach to retirement.

Description of Phased Retirement

Some older workers wish to remain in the workforce, but desire a job that offers reduced hours or reduced physical or mental stress than career employment. Such a job, called a “bridge job” or a “transitional job,” covers the period between career employment and full-time retirement. In essence, such jobs afford workers a so-called “phased retirement.” That is, they do not experience an abrupt termination of full-time work. Instead, a bridge job helps the worker transition from full-time employment to full-time retirement on a schedule that best meets his/her economic and social needs.

Phased retirement benefits not only employees, but employers, too. Retired workers have skills and experience that employers may wish to access on a part-time basis. Although SLGs have successfully created programs that allow retired workers to return to work under certain conditions, they are limited under the current legal structure from offering a broad selection of phased retirement programs. In fact, phased retirement programs, if not structured properly, can reduce a worker’s ultimate retirement benefit. In addition, unless a worker has supplemental funds available, he/she will face lower overall income under such a program. Discussion about these issues appears below under “Impediments to Phased Retirement.”

Structure of SLG Retirement Systems

The universe of SLG retirement systems is large. Approximately 2,200 systems cover some 17 million active and inactive SLG employees and nearly six million retirees. (US Census, Fiscal Year 2000-2001) Defined benefit plans are prevalent in the SLG sector. They cover 91 percent of full-time SLG employees. (Bureau of Labor Statistics, DOL, *Employee Benefits in State and Local Government, 1994*, Bulletin 2477, 1996)

State legislatures, and certain local governments, create the retirement plans that cover their employees and establish the systems that administer the benefits. Decisions about the retirement plans and systems arise in the legislative setting. Constituencies express their views and lawmakers balance competing concerns as they reach agreement on the various issues before their body.

The plan document of a SLG retirement plan is usually found in a statute. The plan document describes coverage, benefits, eligibility, and funding. It also endows some agency to administer the plan.

Many of the state retirement systems have hundreds, and sometimes, thousands of employers (counties, cities, towns, public schools, or special governmental units) who must participate in the system or who have the option to do so. Irrespective of whether a

state uses a mandatory or elective approach, once in the system, the employer must generally cover all of its eligible employees.

Retirement eligibility varies from state to state, but some generalizations exist. One frequent method uses multiple combinations of age and service. For example, someone may retire at age 55 with at least 30 years of service. Another method is “x years and out,” in which an employee can retire at any age after “x” years of service. Some SLGs provide both methods to employees. In Alabama, a teacher may retire at age 60 with ten years of service or any age with 25 years of service. The Bay City (Michigan) Police and Fire Retirement System uses age 55 with ten years of service or any age with 28 years of service. Other jurisdictions use a “rule of” approach, under which an employee qualifies for retirement when his/her age and years of service equal a specified number. Employees of the Tucson (Arizona) Supplemental Retirement System may retire when their age plus years of service equals 80 (e.g., age 55 plus 25 years of service equals 80).

Most retirement plans also provide for early retirement. Under early retirement, an individual receives a benefit over a longer period than if he/she waited until normal retirement eligibility. Thus, if an individual chooses to retire early, his/her monthly benefit amount is generally smaller than what he/she would have received under normal retirement eligibility.

SLGs are innovators of retirement designs that address the needs of employees and employers. In the area of teacher retirement, most states have implemented return to work provisions that allow school districts to hire retirees to work on a part-time or intermittent basis or to help alleviate critical needs. These programs usually permit retired teachers to return to work without loss of their pension benefit, but limitations usually apply. For example, the individual must be in retirement for at least a designated period of time before returning to work, usually from 30 days to one year, depending on the jurisdiction. Moreover, in most cases, the individual may not work more than a specified number of hours per year or earn more than some dollar amount. If the individual exceeds the limits, his/her retirement benefit is suspended or reduced. Some states permit full-time post-employment but usually tailor the programs to assist in relieving a shortage of teachers in a certain geographic or subject area.¹

Return to work provisions differ from phased retirement programs. Under return to work, an individual retires, then returns to work under certain conditions. Phased retirement involves individuals still on the job who transition into retirement through a bridge job. SLGs have created a wide range of return to work programs, some of which

¹ Phased retirement and return to work are not the only programs for workers nearing or at retirement in the SLG sector. Some jurisdictions have adopted another type of program called a deferred retirement option plan (DROP). Under the typical DROP, an individual elects to freeze the value of his/her pension upon reaching retirement eligibility. The individual continues to work for a designated period of time. The retirement system deposits the monthly benefits the individual would have received into an account. When the individual ceases employment and begins to draw monthly benefits, he/she receives the DROP funds as a lump sum or as an annuity. DROPs are viewed as a strategy for encouraging employees to remain in the workforce but preparing them for retirement at the end of a fixed period.

have existed for some time, and are knowledgeable about the challenges in making such programs operate smoothly. Thus, NCTR requests that any guidance from Treasury and the Service address phased retirement only, not return to work.

IMPEDIMENTS TO PHASED RETIREMENT

Two impediments hinder the adoption of phased retirement programs. First, under current law, phased retirement might cause an employee's retirement benefit to lose value. Second, some employees cannot participate in phased retirement because a bridge job alone may not provide them with adequate income.

Under phased retirement, a worker switches from his/her full-time job to a bridge job. As noted earlier, a bridge job offers reduced hours or reduced physical or mental stress in contrast to his/her career job. Accordingly, a bridge job will likely pay a lower salary. The lower salary presents a problem under the typical formula of a DB plan. Such plans generally use a formula that computes benefits largely on a worker's final average salary during the years closest to retirement. (Final average salary, also known as final average compensation or by other terms, is computed by averaging an employee's compensation for some number of years before retirement. Three or five years are common.) If a worker takes a bridge job, he/she will have decreased the final average salary that the retirement system uses to calculate his/her benefit when he/she moves into full-time retirement. Thus, a mechanism must be in place to protect the value of an employee's retirement benefit during a bridge job.

The amount of income available to workers in phased retirement is a second concern. Workers who have supplemental income can easily take a bridge job irrespective of the typically lower compensation. Employees without such resources may be precluded from doing so, however. Many will simply retire even though the employer might wish to retain the employee on a part-time basis. Under current law, it is difficult for SLG employees to access assets in their respective 403(b) or 457 accounts, even when they near retirement age. Were those limitations not in effect, employees could use part of the assets to augment the income from a bridge job.

CONSIDERATIONS ABOUT PHASED RETIREMENT

We request that any guidance incorporate the following general elements.

- Good retirement planning for some individuals means avoiding an abrupt termination of work and, instead, gradually transitioning into a retirement that meets their social and economic needs.
- Phased retirement, also known as transitional retirement, should be defined as work arrangements that permit an individual to move from his/her career position to a position of reduced hours, lower compensation, or reduced physical or mental stress before full retirement. An individual's job during phased retirement is called a bridge job, or a transitional job. Return to work,

on the other hand, should be defined as a program that allows an individual who has retired and then returns to work under a certain set of conditions.

- Any phased retirement guidance should allow SLGs to protect the value of a participant's retirement benefit through a bridge job.
- Any phased retirement guidance should account for the need of some SLG employees to access their respective 403(b) or 457 accounts for supplemental income that will offset the expected lower pay from a bridge job.

In addition, any phased retirement guidance should include the following provisions.

Need for Voluntary Programs Affording Maximum Flexibility

As described above, SLG retirement plans vary widely. Thus, any guidance from Treasury and the Service should meet several objectives. First and foremost, it must allow each individual SLG and its respective retirement administrators to decide whether to adopt a phased retirement program. Moreover, any guidance should allow the maximum flexibility. Of key importance is the right of SLGs to continue to define such terms as normal retirement age, early retirement age, minimum retirement age, and final average salary or compensation (or whatever term is used in a particular jurisdiction).

An additional consideration is the definition of the terms governing phased retirement programs themselves. SLGs have successfully created return to work programs that meet their respective workforce's needs. By extension, SLGs should be endowed with the responsibility of defining the terms used in any phased retirement programs. Such terms include what level of workload reduction would permit in-service distributions.

A compelling reason exists for SLG definition of terms. Federal definitions might inadvertently violate the strong contractual rights underlying the retirement plans for SLG employees. These rights prohibit the diminishment or impairment of retirement benefits. Retirement administrators are in an awkward position when conflicts arise between the federal pension qualification rules and the respective laws of a SLG. If the retirement administrators decide to follow the laws of their respective jurisdictions, they face the possibility of violating the federal pension qualification rules. If they decide to follow the federal rules, they could find themselves in violation of employees' contractual rights.

Another concern is the funding of SLG retirement plans. Funding methods and funding levels vary from state to state. Phased retirement programs might change retirement patterns, thereby affecting funding. Any guidance by Treasury and the Service should not, therefore, require a SLG retirement system to change its funding method or assume additional obligations.

In-Service Distributions Only After Individual is Eligible for a Retirement Benefit or Allowance

The fundamental reason for a retirement program is to provide lifetime income for an individual after his/her career ends. In furtherance of that purpose, federal and state laws allow preferential tax treatment for income deferred for retirement. Moreover, in an effort to prevent individuals from using retirement assets before retirement, the Internal Revenue Code and regulations provide two complementary rules. First, they prohibit distributions from a defined benefit plan before the earlier of normal retirement age or severance from employment. Various distribution limits apply to defined contribution plans. Second, the rules encourage individuals to retain retirement assets when they leave a job by allowing them to rollover the assets into another retirement vehicle. If individuals fail to rollover the assets, they must pay a 20 percent income tax withholding. In addition, those younger than 59½ are subject to a 10% penalty tax in certain circumstances.

Because phased retirement allows for the distribution of retirement funds earlier than usual, it might raise fears that an individual will not have enough income during retirement. NCTR believes, however, that phased retirement is an appropriate component of retirement policy that must be carefully balanced with the need to preserve retirement assets. Thus, NCTR makes the following recommendation. Eligibility for in-service distributions as part of a phased retirement program should be determined by each SLG and only after a member is eligible for a retirement benefit or allowance. We would leave the decision of whether eligibility means earliest retirement eligibility, normal retirement eligibility, or some other criteria to the respective SLG.

Moreover, NCTR believes that all types of retirement vehicles can play a role in phased retirement for SLG employees. The organization recommends that employees be allowed to withdraw funds on a limited basis from voluntary tax deferred plans (Section 403(b) and Section 457 plans are the most common in the SLG sector) once they reach retirement eligibility under their respective retirement plans. Such withdrawals could help supplement the income of individuals in a phased retirement program.

No Guidance Needed on Return to Work Issue

As noted above, we strongly recommend that any guidance from Treasury and the Service not include return to work programs. SLGs are knowledgeable about these programs because they have had them in place for some time.

RESPONSE TO QUESTIONS POSED IN NOTICE 2002-43

The foregoing discussion serves as a backdrop to NCTR's responses to the questions in the Notice.

Under what circumstances, if any, would permitting distributions from a defined benefit plan before the employee attains normal retirement age be consistent with the

requirement that a defined benefit plan be established and maintained primarily for purposes of providing benefits after retirement?

The purpose of SLG retirement plans is to provide employees with income during their retirement years. Federal policies, as well as those of SLGs, reinforce that view, as described in the section above entitled “In-Service Distributions Only After Individual is Eligible for a Retirement Benefit or Allowance.” Phased retirement does not involve a lump sum distribution of an individual’s retirement income. Such a result would deplete the individual’s retirement income and undermine both the purpose of retirement in general and phased retirement in particular. Instead, phased retirement programs can be established that meet employers’ and employees’ needs without harming an individual’s future retirement income. Stated differently, phased retirement is a subset of retirement policy because it involves only a portion of an individual’s benefit.

Would bright-line rules in this area be beneficial?

NCTR favors bright-line rules only to the extent that they: 1) allow voluntary phased retirement programs; 2) allow SLGs to retain the power to define such terms as retirement eligibility and to have the power to define the terms governing phased retirement programs; and 3) prohibit in-service distributions before the member is eligible for a retirement benefit or allowance.

Would it be relevant to consider whether an employee has attained early retirement age under a plan?

Yes. As noted above, NCTR believes that in-service distributions should be permitted only after an individual becomes eligible for a retirement benefit or allowance. Individual SLGs should have, however, the flexibility to decide whether participation in phased retirement should be tied to earliest retirement eligibility, normal retirement eligibility, or some other criteria.

Would it be relevant to consider the extent to which an employee has actually reduced his or her workload?

No. NCTR considers such concerns as the definition of reduced workload to be design issues. Moreover, phased retirement does not always involve reduced workload. It might include, for example, an opportunity for workers to change to a lower stress (and presumably lower compensated) but still full-time job. Each SLG should have the authority over such concerns when designing a phased retirement program.

FINAL THOUGHTS

We recognize that the Age Discrimination in Employment Act (ADEA) is not under the purview of Treasury or the Service. NCTR requests, however, that Treasury and the Service initiate discussions with the relevant federal agencies about the need to ensure that phased retirement programs and ADEA are in harmony.

In sum, we commend Treasury and the Service for their interest in the issue of phased retirement. The issue is not simple because few precedents are available for guidance. We look forward to working with you further on the issue.

Sincerely,

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