



# AMERICAN ACADEMY *of* ACTUARIES

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December 30, 2002

CC:ITA:RU (Notice 2002-43)  
Room 5226  
Internal Revenue Service  
POB 7604 Ben Franklin Station  
1111 Constitution Avenue, NW  
Washington, DC 20244

Dear Sir/Madam:

The American Academy of Actuaries' Pension Committee<sup>1</sup> appreciates the opportunity to comment on the importance of phased retirement as a means to address some of the issues faced by companies as they deal with shrinking labor supplies and the aging of the workforce. Facilitating phased retirement is now more important than ever, as employees face increased life expectancy and the desire to remain active. The specific business issues related to the aging workforce vary by company and industry. However, they can be particularly severe in companies that have experienced significant downsizing in the last decade, since the employees laid off are often those with less seniority.

*Employee perspective:* At present, many individuals are opting to leave the labor force in steps, in effect, creating their own personal phased retirement programs. There are several different ways that they do this: retire from one company and get a job at another, often part-time; retire and then get rehired, usually on a limited basis by the same employer; or phase out gradually before actually retiring. The 2001 Employee Benefit Research Institute (EBRI) Retirement Confidence Survey<sup>2</sup> indicates that employees often want to continue to work after retirement due to a combination of personal preference and economic need.

Individual circumstances vary. There are situations where someone is offered an attractive early retirement benefit (with or without an early retirement window), and prefers to retire and take the benefit but not leave the labor force entirely. Today employees have jobs that require a heavy commitment of time and energy, 50-60 hours a

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<sup>1</sup> The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

<sup>2</sup> Employee Benefit Research Institute, EBRI 2001 Retirement Surveys: Retirement Confidence Survey (RCS), Minority RCS, and Small Employer Retirement Survey (SERS), EBRI Issue Brief Number 224, June 2001.

week or more. For such people, their full-time job is all consuming, and they often seek to retire as early as possible and move into a job with a more reasonable commitment. Others want more time off, have a hobby or interest they want to pursue, want to travel, or have care-giving responsibility so that adjusting their work schedule is very attractive. Others want more time off but do not want to be disengaged, and for them a reduced schedule can be an ideal option. Others would prefer retirement entirely, but cannot quite afford it, so they opt for retirement but supplement their income with some part-time work. In other cases, people retire, expecting that they have enough resources, and then discover that they would really like to have or need more financial resources.

The EBRI survey also found that 26 percent of current retirees say they have worked either full-time or part-time since they retired. In addition, a 1999 AARP survey found that eight in 10 baby boomers plan to work at least part-time during their retirement.<sup>3</sup> A recent Congressional Research Service paper<sup>4</sup> noted that 20 percent to 40 percent of workers in their 60s are working part-time.

*Employer perspective:* Until now, except in certain occupations like nursing, the talent loss expected as the “Baby Boom” generation retires has not been a major problem. The situation is expected to change in the next few years, with the issues of retention of talent, transitioning knowledge, and mentoring newer workers becoming more important. There have already been many cases where companies have sought to keep individuals, often by rehiring retirees, in order to keep needed skills and talent. The issues surrounding the aging workforce also interact with other forces. For example: “U.S. defense agencies and aerospace companies are launching knowledge management programs in an effort to mitigate what some are calling a national disaster – the tremendous loss of expertise caused by a decade of budget cuts, downsizing and an aging workforce.”<sup>5</sup>

*The regulatory environment:* The current qualified plan rules do not facilitate, and in some cases impede, phased retirement. They also create uncertainty around the rehiring of retirees. Other rules create uncertainty with regard to the possibility of triggering age discrimination problems. The legislative and regulatory rules related to phased retirement issues need to be addressed in order to make phased retirement practical for both companies and employees. It should not be more attractive for employees to retire and go to work elsewhere than to stay with the current employers. As employers are limited in the options they can offer, all too often this is the case. We have noted below several of these issues and suggestions for resolution that will support an employer who wishes to implement a flexible phased retirement system.

*Why Both Phasing Out and Rehiring Retirees are Important Options for Employees and Employers:* A reduced schedule before retirement will work well for some types of jobs

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<sup>3</sup> “Baby Boomers Envision Their Retirement: An AARP Segmentation Analysis,” Roper Starch Worldwide and AARP, February 1999.

<sup>4</sup> “Older Workers: Employment and Retirement Trends”, Congressional Research Service, October 18, 2002.

<sup>5</sup> “Industry’s Loss of Expertise Spurs Counterattack”, William B. Scott, Aviation Week & Space Technology, March 13, 2000.

and fit well into employee preferences. In other cases, employers may prefer not to commit to continued employment but would want retirees to fill in as temporary help is needed or as projects come up that can be done on a consulting basis. Likewise, some employees may want to commit to ongoing work but at a reduced pace. Others prefer to leave their time available for travel and personal interests but are happy to work on an “as-needed” basis. All of these options should be available to employers as they structure programs, and they should be available without undue legal risk.

### **Summary of Key Issues for Defined Benefit Plans**

There are several key issues to consider in allowing phased retirement in defined benefit plans, many of which have been addressed below with a suggested framework:

*Voluntary Nature* – Plans should not be required to provide special phased retirement benefits. The U.S. private pension system is voluntary, and requiring companies with plans to provide phased retirement benefits should not be an additional requirement placed on companies that wish to provide their employees with pension benefits. However, if a company wishes to offer phased retirement through their pension plan, they would need to comply with existing, as well as new, rules and regulations. Companies that decide to have a phased retirement program should set up a formalized program and set of procedures. Employees should be able to voluntarily elect to become a participant in the phased retirement program. Participation would also rest on the availability of a position that would be practicable on a phased basis. A phased retirement option should work similar to programs companies currently offer to employees who want to work on a part-time basis after working full-time but it should not be a legislated job entitlement.

*Eligibility* – A plan’s early retirement eligibility provisions should be applied consistently to both full and phased retirement. In addition, a participant must meet some minimum threshold to be eligible for phased retirement, such as a reduced work schedule of at least 20 percent. There should be flexibility in meeting this requirement so that it does not become an administrative burden. For example, if an employee is asked to work full-time for a few weeks while on a part-time schedule, or takes compensatory time or an unpaid vacation, it should not cause the pension and pay amounts to change. Another example would be someone who is working on an hourly basis, where the employee’s actual reduction in time worked for a year may not be determinable until the end of the year.

*Threshold Age/Service* – Prior proposed legislation set age 59-1/2 as the age after which in-service distributions can begin. However, few, if any, plans use age 59-1/2 as the plan’s earliest retirement age. Earliest retirement ages vary by plan and can be based on: (a) a minimum age (e.g., age 55), (b) a minimum age and years of service (e.g., age 55 with 10 years of service), (c) a total of age and service (e.g., a total of age and years of service greater than 70), (d) a minimum years of service (e.g., 30 years of service), or (e) a combination of all of these. If the age threshold for phased retirement is set at 59-1/2, employees could lose some of their early retirement subsidies if they have to wait until age 59-1/2 to phase into retirement. Instead of waiting until age 59-1/2, an employee may choose to retire at age 55 with the full early subsidy and go to work full- or part-time

for another company. This is very expensive for a company and disruptive to an employee. Therefore, we suggest the minimum age threshold for phased retirement should be the plan's earliest retirement age and that benefits that commence under such provisions be excluded from the excise tax on benefits that commence prior to age 59-1/2.

*Discrimination* – If a plan offers phased retirement on the basis of a reduced schedule and partial pension payment before retirement, it should be uniformly available to all employees who meet the minimum age or service requirements. If it is not uniformly available, the nondiscrimination test for benefits rights and features must be met based on the group actually offered the opportunity. This could be done on an individual-by-individual basis, determined by skill sets, workforce needs of the employer, etc. Although the program should be uniformly available, as noted above, whether an employee can phase into retirement must be dependent upon the availability of a part-time position. If there is a program for rehire of retirees, such as through a retiree temporary pool or for-project work, this should be limited to people who qualify for the work. The application of pension rules to those employees who are rehired should also be uniform. Whether an employer offers an employee continued employment (full-time or part-time) is an employment practice governed by the Equal Employment Opportunity Commission (EEOC) and should not be addressed in pension legislation.

*Payment Amount* – The amount of benefit to be paid at phased retirement should be flexible. For example, for salaried employees, it could be based on the “deemed percent retired” (e.g. - a percentage elected by the participant under the terms of the plan, the percent of time the employee no longer works when compared to a full time schedule, etc.). For example, if a participant who is scheduled to work 40 hours a week reduced his work schedule to 24 hours a week, he is 40 percent retired (16 hours no longer working divided by 40 hours when full time). Upon phased retirement, a participant who meets the eligibility criteria should receive the benefit that would have been payable to him had he retired, multiplied by his “deemed percent retired.” For hourly employees, it could be based on the actual number of hours worked during the year compared to a full-time number of hours.

*Form of Benefit Payment* – Upon phased retirement, a participant should be eligible to receive his benefit under any form of payment that would otherwise be available upon full retirement at that date. Once the participant elects a form of payment and receives spousal consent for that payment, however, the employer should be allowed to lock that form of payment in for the remainder of the participant's lifetime. As the participant increases his percent retirement, this same form of payment would be applied to the new portions of his benefit. This would be easier for an employer to administer than requiring a company to reevaluate the benefit and form of payment each time a participant changes his deemed percent retired. Nevertheless, if desired, an employer should be allowed the flexibility to offer new benefit form elections upon a change in a participant's deemed percent retired. If a participant's marital status changes, the participant should also be allowed to change his election as he increases his percent retirement in the future based

on the increase in benefits received. Employers should also be given the flexibility to provide the new form on the whole benefit received.

*Death While Partially Retired* – If a participant dies while partially retired, the portion of the benefit commenced should be paid to the participant's beneficiary based on the form of payment elected. However, the same death benefit provisions that apply to a participant who dies prior to retirement should cover the remaining portion of the benefit that had not commenced.

*Future Benefit Adjustment* – One of the most complex issues with respect to phased retirement is how benefits continue to accrue and are adjusted in the future based on the earlier commencement of a portion of the benefit. Because of the distinct differences in the nature of benefits, we suggest that this be addressed separately for account-based plans (such as cash balance and pension equity plans) than non-account-based plans (such as traditional defined benefit plans). We have suggested one methodology for each of these plan types; however, there should be flexibility allowed to reflect different employment situations and plan designs.

*Account-based Plans* – For account-based plans, an amount should be withdrawn from the account upon phased retirement based on the deemed percent retired. The remaining account balance should continue to accrue interest as provided in the plan. For purposes of determining the amount of future benefits accrued under the plan, the annual accrual should be added based on the participant's full-time salary and service and then prorated for the percent of the time the employee works (or one minus the deemed percent retired). By doing this, the participant's full-time salary would be compared to the compensation limit and integration point prior to reflecting the change in status. This would allow participants to continue to accrue the same level of benefits as they did prior to retirement, as adjusted for their reduced work schedule, and avoids the prohibition on double proration described in Department of Labor Regulation Section 2530.204-2(d).

*Nonaccount-based Plans* – Upon retirement, a percent of the monthly benefit should commence based on the deemed percent retired. The monthly benefit should be based on the accrued benefit, including the final average pay (or annual pay or service, if applicable) and early retirement subsidies available, had the participant fully retired. As the participant continues to accrue benefits, the annual equivalent benefit accrual should be calculated based on full-time salary and service, after which the full-time accrual is prorated for the percent of the time the employee works (or one minus the deemed percent retired). This solves one of the problems that may occur in some final average pay plans. Many final average pay plans only look to recent salary history, such as the average of the salary for the highest five out of the most recent ten years of employment. If a participant becomes part-time, his earnings are reduced and those lower amounts begin to replace his higher earnings in the most recent ten years. Therefore, at full retirement, his benefit could actually have decreased because of his part-time

status. Looking at these accruals on a full-time basis and then prorating them for the part-time status, eliminates the effect of diminished final average pay.

*Floor/offset plans* – Floor/offset plans have special considerations because of the different rules for the defined benefit and the defined contribution portions of the benefit. In drafting the phased retirement rules, treatment for both the defined benefit and the defined contribution portions of the benefit should be more consistent.

When a participant increases his deemed percent retired, a percent of his remaining benefit will commence and be subject to the early retirement subsidies in effect at his second retirement date. This solves the problem of people losing some of their future benefit accruals due to large early retirement subsidies at their first retirement date. For example, the rules on post 70-1/2 in-service withdrawals allow benefit accruals to be offset by the “value” of the benefit payments already received. Under phased retirement, the first retirement date could be at a time of high early retirement subsidy. As the participant ages, the amount of the early retirement subsidy decreases, but the value of the payments received that must be offset still includes the value of the high early retirement subsidy. This could eliminate future benefit accruals, in effect freezing the participant’s benefit at the first retirement date. By treating the new benefit portion as a separate benefit amount, instead of offsetting for benefits paid, this frozen benefit effect is eliminated.

When a participant decreases his deemed percent retired, a percent of the benefit he is receiving will cease. Any benefit adjustment would then be covered under the rules for rehired employees.

*Partial Termination of Employment* – It would be helpful to add a formal definition of “Partial Termination of Employment” to the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act (ERISA) to be used in describing the phased retirement framework.

*Highly Compensated Employees* – When determining whether or not a participant is a highly compensated employee, his actual salary should be evaluated, not his annualized salary. This will allow the correct classification of participants who were highly compensated prior to partial retirement but may no longer have the pay or position to be a highly compensated employee after partial retirement.

*Maintenance of Income* – Companies generally do not like to provide participants with more income after retirement than the participant could receive as an active employee. They are able to restrict defined benefit payments to 100 percent of average pay through IRC Section 415. Upon phased retirement, companies should be allowed to restrict the total of the pension benefits paid and the partial salary earned to the amount of the participant’s full time annualized salary.

*Small Benefit Provision* – If the annual benefit payable to the participant upon phased retirement is less than a certain small amount, the employer should be allowed to provide the participant with the entire benefit upon phased retirement.

*Maximum Benefit Limitation* – The maximum benefit limitations add an additional level of complexity to phased retirement. We would be happy to help you work on a solution to reflect these limitations once the rest of the phased retirement rules are designed.

*Rehired Participants* - If one accepts a broad definition of phased retirement, much of the activity to date has been the utilization of retirees for some continued work. The methods of utilizing retirees differ and include rehire on a full-time or part-time basis and the use of contractors often working through outside services, consulting, and/or retiree pools. Traditional defined benefit plans nearly always include suspension of benefits provisions, so that if benefits are paid as regular income and the individual returns to work, benefits are discontinued. It is our impression (not supported by data) that nearly all retirees in single employer plans are rehired without a suspension of benefits. In fact, often the arrangements made specifically address how to rehire without suspension. While suspension is not an issue for employees who took a lump sum from plans with such an option, recalculation of benefits may be. Some public sector groups have special provisions to allow rehire without suspension in the event of critical needs.

In light of the provisions of the benefit plans, rehire often turns out to be the best option. There are legal uncertainties, however, surrounding this practice. A termination must be a bona-fide termination, or there is legal risk to the plan and the employer upon rehire. Many companies impose a waiting period before an employee is rehired in order to ensure that the termination was bona-fide, while a few prohibit rehire entirely. Discussions with a number of attorneys indicate that there are no clear tests for when rehire is acceptable, and different companies have different views. Better definitions and the ability to rehire retirees without risk, at least on a part-time basis, would be helpful. Safe harbors, once defined, would also be valuable.

Retiree pools are used by some organizations in lieu of outside temporary help. Some companies have used this type of arrangement for many years (e.g., Travelers Insurance Company was cited as an example of such arrangements about 20 years ago). This is a good system for the retiree who wants to work when available and on a limited basis, and it is better for the company than hiring outside temporary employees. Safe harbors should also be defined for retiree pools.

The question might be asked as to whether it is better to rehire retirees or to phase out before retirement. If the benefit plan works well to support the arrangement and both employer and employee want to continue with a definite, committed work schedule, it should be better to phase out before retirement. However, if the employer prefers to use the retirees as needed without commitment to a regular schedule, then rehiring retirees is better. Likewise, if the retiree wants complete freedom to travel and to participate in other activities, but is happy to work when available, being rehired is the best

arrangement. We feel that the employer should have freedom to offer both types of arrangements.

Suspension of benefit rules are currently in place. Employers are not required to include suspension rules in their plans, and they do not create a barrier to phased retirement. When benefits are suspended, additional benefits are earned and adjusted. The basis for adjusting benefits should be reasonable based on the adjustment of benefits for phased retirees who are getting partial pensions.

*411(d)(6) Treatment* – Any amendment purely to add a phased retirement provision should be provided a waiver from the anti-cutback provisions of IRC Section 411(d)(6), and it should not be included as part of the plan's accrued benefit. Otherwise, it would be too administratively burdensome to add such a provision.

*Age Discrimination in Employment* – ADEA is beyond the specific professional expertise of actuaries. We want to point out, however, that there is a great deal of uncertainty with regard to ADEA whenever any type of program for older employees is implemented. Some well-defined safe harbors would be helpful.

*Protecting Employees* – There have been highly publicized concerns about "leakage," including employees outliving their retirement income and savings when they receive their benefits in a lump sum. Phased retirement provides an opportunity for participants to decrease leakage by not forcing them to retire and take their entire benefit.

*Defined Contribution Plans* – This paper deals solely with defined benefit plan issues in connection with phased retirement. While these phased retirement ideas work better in a defined benefit plan environment, some of the issues in this paper may also be applicable to defined contribution plans. Any differences in rules between the two plan types, including any provisions with respect to phased retirement, should be minimized so that there are no advantages of one type of plan over the other.

We want to thank you for this opportunity to share our thoughts on how to implement phased retirement programs in the pension arena, and we would be interested in meeting with you to discuss these ideas. Please contact Heather Jerbi, the American Academy of Actuaries' pension policy analyst, at 202-223-8196 if you have any questions or would like more information.

Sincerely,

A handwritten signature in cursive script, reading "Donald J. Segal".

Donald J. Segal, FSA, MAAA  
Chair, Pension Committee  
American Academy of Actuaries