



National Association of State Retirement Administrators

**Phased Retirement Overview:  
Summary of Research and Practices**

**Prepared by Keith Brainard  
October 2002  
for the  
NASRA Phased Retirement Committee  
Laurie Hacking, Chair**

**Table of Contents**

<b>Definition</b>	<b>1</b>
<b>IRS Request for Comments</b>	<b>1</b>
<b>Factors Driving the Phased Retirement Discussion</b>	<b>2</b>
<b>Phased Retirement in the Public Sector</b>	<b>3</b>
<b>Benefits of Phased Retirement</b>	<b>3</b>
<b>Concerns about Phased Retirement</b>	<b>4</b>
<b>Barriers to Implementing Phased Retirement</b>	<b>5</b>
<b>Proposed Regulatory Solutions</b>	<b>6</b>
<b>Proposed Legislative solutions</b>	<b>7</b>
<b>Models and Practices</b>	<b>8</b>
<b>Summary</b>	<b>11</b>
<b>References</b>	<b>12</b>

## **Definition**

There is no single, recognized definition of phased retirement. The term may be described as a broad range of employment arrangements, formal and informal, that allow an employee who is approaching normal retirement, to continue working, usually with a reduced workload, in transition from full-time work to full-time retirement.

Phased retirement takes many forms, including part-time, seasonal, or temporary work, an extended leave of absence or a deferred retirement option plan (DROP).

*The definition of phased retirement that will be used in this overview is limited to employment arrangements prior to the employee's effective retirement date.*

## **IRS Request for Comments**

The IRS request for comments on phased retirement seeks input “regarding approaches for encouraging employees and employers to provide opportunities for employees to continue active employment and suggestions for areas in which additional guidance might be appropriate.”

One industry source<sup>1</sup> says the IRS is concerned about the effect of phased retirement on the integrity of the pension system: “A phased retirement arrangement that begins before normal retirement age does not meet the current definition of ‘retirement.’ The IRS specifically requested comments on how phased retirement arrangements could be consistent with the policy goal that qualified pension plans provide benefits after retirement. . . . The IRS is also considering how phased retirement would affect the employee's ultimate retirement benefit, such as whether and how benefits would be affected by the reduction in compensation, and how early retirement subsidies would be taken into account.”

Comments are due by January 1, 2003.

---

<sup>1</sup> “IRS Requests Comments on Phased Retirement, Eliminating Optional Forms of Distribution,” Watson Wyatt *Insider*, August 2002

## **Factors driving the discussion on phased retirement**

- Employers are seeking ways to retain experienced employees, as the slower rate of growth in the number of workers entering the workforce is projected to result in a growing labor shortage.
- Employees are working longer. Since 1985, the long-running trend toward an earlier retirement age has stopped and may have begun to reverse.<sup>2</sup>
- The Social Security retirement age is gradually increasing to age 67.
- A growing consensus exists that the nature of retirement is changing. No longer do most workers wish to experience a sudden end to work, followed by an equally sudden onset of full-time retirement. Instead, many workers wish to ease in to retirement, transitioning out of the workforce with a reduced workload.
- Congress in 2000 approved the elimination of the Social Security earnings test for persons age 65 or older, freeing retirees to work and earn as much they wish without losing Social Security benefits.
- Social Security is increasing the delayed retirement credit (DRC), the reward for delaying initial benefit receipt past the normal retirement age. This credit will increase from three percent per year of benefit delay to eight percent by 2008.
- The Phased Retirement Liberalization Act was introduced in Congress in 2000. This bill would have permitted defined benefit pension plans to make in-service distributions at the earliest of age 59½, 30 years of service, or the pension plan's normal retirement age. Although it did not pass, the bill is a sign of congressional interest in accommodating employers and employees seeking flexible work arrangements.
- An increasing number of retirees are facing financial limitations, requiring them to continue working.

---

<sup>2</sup> David Rajnes, "Phased Retirement: Leaving the Labor Force," *EBRI Notes*, September 2001

## **Phased retirement in the public sector**

Industries where phased retirement programs are most prevalent are education (especially higher education), and the public sector. Much of the phased retirement activity in the public sector involves public school teachers and administrators, as existing and projected teacher shortages have created a demand for incentives to encourage members of these employee groups to continue working.

In recent years, many state legislatures, responding to a shortage of teachers and other specific employee groups, have approved changes in plan design that allow retired employees to return to work while continuing to receive their pension benefit. Such programs usually feature one or more of the following limitations:

- the participant must have been retired for a designated length of time (typically ranging from 30 days to one year)
- the participant may work only a limited number of hours within a year
- the participant may return to service only for a limited period of time

Incentives to continue working that take the form of *post-retirement* return-to-work programs are outside the scope of this overview. However, if public pension plans were to receive the authority and guidance needed to establish *pre-retirement* incentives to continue working, as opposed to the limitations that presently exist on pre-retirement reduced service arrangements, it is likely that such programs would be implemented on a wide scale by plans that provide pension benefits for public school teachers and other groups of public employees.

## **Benefits of phased retirement**

The chief advantages of phased retirement programs for employers are:

- retention of trained and qualified personnel, especially for positions that are difficult to fill
- reduced costs associated with training new employees to replace retiring employees
- reduced costs achieved through lower salary and benefits expenses, made possible by employees shifting from full-time to part-time status

The chief advantages of phased retirement programs for employees are:

- flexible work arrangements
- the opportunity to gradually transition into retirement rather than making a sudden, abrupt shift
- the opportunity to supplement retirement income or to increase future retirement benefits by deferring current retirement income

## **Concerns about phased retirement**

### *Increasing Plan Costs*

Modifying the design of a DB plan to implement phased retirement programs can impose new liabilities on a retirement plan. Plan designs that permit an employee to work fewer hours, for a shorter period of time, or that allow pension benefits to be paid earlier, typically increase the plan's actuarial costs. However, phased retirement plans can be designed to be actuarially neutral.

### *Double Dipping*

Double dipping occurs when a retired employee simultaneously receives both a pension benefit and paycheck. Double dipping can cause a negative reaction from a participant's co-workers, the media, and the general public, possibly resulting in workplace morale issues and negative publicity about public pension plans.

### *Effect on Spousal Benefits*

"Depending on the impact of phased retirement on the participant's accrued benefit, the spousal benefits may be smaller as a result of phased retirement. Assuring adequate spousal consent for in-service distributions provides some level of spousal protection. However, the spouse does not formally consent to a reduced work schedule and the resulting reduced pay that has the biggest impact on the spousal benefits provided by defined benefit plans. [Changes to pension law and regulations] should include safeguards to protect workers and their spouses as they make decisions that will have a lifetime financial impact."<sup>3</sup>

---

<sup>3</sup> Patricia L. Scahill and Jonathan Barry Forman, "Allowing Phased Retirement Helps Both Employees and Employers," *The Actuary*, March 2002

## **Barriers to implementing phased retirement**

A number of obstacles—regulatory, legal, and fiscal—can complicate efforts to create and maintain a phased retirement program. Of these, the primary barriers are regulatory, especially in the form of the Internal Revenue Code. The IRS request for comments is an effort to consider revisions to these regulations.

### *Regulatory Obstacles*

Internal Revenue Code (IRC) limitations facing DB plans complicate participation in phased retirement plans. These limitations are in sharp contrast to DC plans, where the predominant limitation to phased retirement is the age (59½) at which participants may begin receiving in-service distributions. Other regulatory barriers complicating DB plan sponsor efforts to enact phased retirement programs include:<sup>4</sup>

- IRS regulations prohibit DB plans from making distributions to participants until they have terminated employment or attained normal retirement age. Yet many workers wish to retire gradually, moving from full-time to part-time, supplementing their reduced pay with pension benefits.
- Whether and how phased retirement arrangements comply with the Age Discrimination in Employment Act (ADEA) is unclear.

### *Legal Obstacles*

Traditional DB plan design, codified in the laws governing public retirement systems, is inconsistent with the concept of phased retirement. Based on the method that is used to calculate retirement benefits in a typical DB plan, an employee wishing to ease into full retirement by working part-time usually will diminish his or her retirement benefit.

Also, eligibility for health care benefits can be an issue. Medicare is available only to those aged 65 and over, and some part-time, temporary, and seasonal employees do not qualify for their employer's health care coverage. As a result, retiring prior to age 65 can challenge many workers' ability to afford health care coverage.

### *Fiscal Obstacles*

Some proposals for accommodating phased retirement programs, such as lowering the normal retirement age or loosening in-service distribution rules, can increase a pension plan's liabilities and cost.

---

<sup>4</sup> Yung-Ping Chen and John C. Scott, "Gradual Retirement: An Additional Option in Work and Retirement," Presented at Retirement Implications of Demographic and Family Change Symposium, Sponsored by the Society of Actuaries, San Francisco June 2002

## **Proposed regulatory solutions**

In testimony before the Working Group on Phased Retirement, ERISA Advisory Council, James Klein said, “Flexibility must be a guiding principle of any policy initiative affecting phased retirement if such initiative is to meet with success in today's workplace.”<sup>5</sup>

### *Pension Reductions*

“Pension law and regulations should clarify whether a defined benefit pension based on final average pay could be reduced if a participant’s salary is reduced because of participation in a gradual retirement program. If pension law is clarified to permit such reductions, participants should be notified if a change in pension benefits will be affected by a change in their employment status.”<sup>6</sup>

### *In-Service Payments*

“Employees often terminate employment to obtain an early retirement subsidy or enough money to enable them to work part-time for another employer. Present-law restrictions on in-service distributions limit employers' ability to prevent such terminations. To address this problem, [the authors] recommend that defined benefit plans and 401(k), 403(b) and 457 plans be permitted to make in-service distributions to older employees who have attained a specified age, who have completed a specified amount of service, or who have achieved a specified combination of age and service. Of course, an employer may decide not to offer these in-service distribution options at all under its plan, or could decide to offer them only to a nondiscriminatory subset of the employees who have qualified for it.”<sup>7</sup>

“Under [a program allowing in-service distributions], employers could set a “floor” age and/or service requirement, such as attainment of age 50 or 25 years of service, according to their particular workforce demographics. In order to allow payments under the proposed Phased Retirement Liberalization Act [discussed previously], an exception from the ten percent additional tax on early pension payments should be made for benefits paid after the attainment of a specified age or amount of service.”<sup>8</sup>

---

<sup>5</sup> James Klein, comments before the Working Group on Phased Retirement ERISA Advisory Council, U.S. Department of Labor Washington, D.C. July 17, 2000

<sup>6</sup>Chen and Scott.

<sup>7</sup> James Klein, comments before the Working Group on Phased Retirement ERISA Advisory Council, U.S. Department of Labor Washington, D.C. July 17, 2000

<sup>8</sup> Chen and Scott.

*Age Discrimination Relief*

Congress should direct the Department of Labor and the Equal Employment Opportunity Commission to collaborate on a review of the application of the age discrimination laws on gradual retirement programs. The agencies should also be directed to use their regulatory authority to facilitate the implementation of gradual retirement programs while ensuring that the protections for older workers are not diminished.<sup>9</sup>

*Unknown Regulatory Barriers*

It is important that any regulatory guidance provide flexibility for employers who sponsor bona fide gradual retirement programs. For business reasons, employers will need to retain reasonable discretion to determine who is eligible for a gradual retirement program and to modify the eligibility rules as reasonably necessary.<sup>10</sup>

**Proposed legislative solutions**

*DB Plan Design*

- *Lower the normal retirement age for DB plans.* This allows employees to receive pension income sooner and to consider a reduced workweek and paycheck.<sup>11</sup>
- *Eliminate subsidies that encourage early retirement.* Some plan designs that allow early retirement, and early retirement incentive windows, not only discourage phased retirement participation, but also impose an actuarial cost to the plan.<sup>12</sup>
- *Offer a two-tiered DB plan.* Under this scenario, one plan has a lower normal retirement age (e.g., 60), allowing employees to collect part of their pension. Upon attaining the higher normal retirement age (e.g., 65), employees are eligible for the remainder of their pension. Plans can be structured so that employees who work until age 65 will earn the same pension as they would have under the former, one-tier plan.<sup>13</sup>
- *Annualize Phased Retirement Pay.* “To be sure that the worker gets the benefit of pay rate increases during phased retirement, the plan could annualize pay during phased retirement years. This approach is similar to the approach many plans use for participants who do not work a full-time schedule. Under this approach, if the plan credits a partial year of

---

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

<sup>11</sup> Laurene Graig and Valerie Paganelli, Watson Wyatt, “Current Practices in Phased Retirement: Transforming the End of Work” 1999

<sup>12</sup> Ibid.

<sup>13</sup> Ibid

service for a year in which a participant works less than a threshold number of hours, a participant working part-time while phasing into retirement would receive a partial year of service. The plan would then annualize the worker's compensation for that year. For example, a plan could credit a half-time worker with a half a year of benefit accrual service and annualize the worker's salary by doubling it."<sup>14</sup>

### *Health Care Benefits*

- *Retention of health care coverage.* Provide credits and cost-sharing adjustments for part-time workers. Many employees will defer retirement or phased retirement due to health care concerns. Design health care plans so the employee retains health care coverage when working part-time.<sup>15</sup>
- *Changes to federal law.* To alleviate the barriers to health care for participants in phased retirement programs, Congress could consider the following:
  - Allow the purchase of Medicare coverage between the ages of 55 and 65 at a rate that is commensurate with group insurance policies that provide similar benefits but without consideration of insurability and pre-existing condition requirements.
  - Extend the total COBRA period for employees losing coverage after age 55 to the lesser of (a) the period of time to Medicare eligibility, or (b) the period of coverage with the employer prior to the COBRA period.<sup>16</sup>

## **Models and Practices**

An overarching theme of phased retirement arrangements is that they differ from one industry to another and from one organization to the next. They range from informal to formal, and eligible employees range from those selected individually to designated groups of employees to all employees. Some programs are highly structured; others are ad hoc and flexible.

A spate of state legislation in recent years allows public employees, particularly school teachers, who have reached normal retirement, to continue working and to earn a lump sum pension payment that supplements their normal pension annuity benefit. One popular method for achieving this is through a deferred retirement option plan (DROP). DROP allows a participant who qualifies for normal retirement to continue working. The participant's retirement benefit is

---

<sup>14</sup> Patricia Scahill and Jonathan Barry Forman, "Protecting Participants and Beneficiaries in a Phased Retirement World,"

<sup>15</sup> Ibid.

<sup>16</sup> Chen and Scott

deferred and deposited into a separate account. When the participant terminates (typically one to five years later), they are entitled to a lump sum payment of the pension benefits that have accumulated in the separate account, and a pension annuity benefit begins.

The State of Florida offers a DROP to all state employees who are eligible for normal retirement. Employees typically continue working in their same division and job; the DROP period may last up to 60 months.

An innovative variation on a DROP, provided by the Virginia Retirement System, is known as a PLOP—partial lump-sum option payment. PLOP allows employees who qualify for normal retirement to remain in service for one to three additional years beyond their normal retirement date. Those who elect this option receive a lump-sum payment equal to 12, 24, or 36 months of their monthly pension benefit, depending on whether they remain in the program for one, two, or three years. No reduction is made in the employee’s retirement benefit, and the retirement benefit continues accruing while the employee is in PLOP status. This PLOP differs from most DROP’s because it is a pre-retirement work arrangement.

A 1999 Watson Wyatt Survey Report,<sup>17</sup> “Phased Retirement: Reshaping the End of Work,” identifies the various forms of phased retirement found in its survey of 586 employers, representing private, public, and non-profit sectors and institutions of higher education. These forms, and participation rates among those surveyed, are:

Hire retirees as part-time/temporaries	75%
Reduced workdays/workweek	60%
Hire retirees as consultants	42%
Job transfer	32%
Extended leaves of absence	23%
Job sharing	19%
Seasonal employment	18%
Alternative career paths	8%

Watson Wyatt’s report also describes a number of other phased retirement plans:

- Faculty members of the Cincinnati Children’s Hospital Medical Center are eligible to participate in its phased retirement program. The program is informal; department heads are permitted to design individualized phased retirement arrangements and to negotiate with their department staff continued employment at reduced work hours, while receiving pension benefits.

---

<sup>17</sup> Graig and Paganelli

*Phased Retirement Overview*

- The National Benevolent Association allows employees to customize their own phased retirement arrangements.
- The phased retirement program offered by the University of Idaho allows participants to continue to earn full service credit for retirement benefits as long as they work at least half-time. These participants also continue their coverage under the active medical plan.
- The City of San Diego is considering allowing retirees to work half-time and receive half of their pension benefit.

## **Summary**

The IRS request for comments on phased retirement is a result of many factors, including a growing labor shortage and changes in the traditional transition from work to retirement. Some features of the Internal Revenue Code are inconsistent with these factors, and the IRS request for comments is part of an effort to examine regulations governing pensions, especially defined benefit plans, that inhibit the ability of employers and employees to establish working relationships that meet the needs of both parties. Modifications to the design of DB plans and to health care plans and laws also are needed to fully address the phased retirement issue. Formal and informal phased retirement programs are being instituted within many industries, especially in the public sector and among public school districts and their employees.

## **References**

Chen, Yung-Ping and John Scott, "Gradual Retirement: An Additional Option in Work and Retirement," Presented at *Retirement Implications of Demographic and Family Change* Symposium, San Francisco, (Sponsored by the Society of Actuaries, June 2002)

Graig, Laurene and Valerie Paganelli, Watson Wyatt, "Current Practices in Phased Retirement: Transforming the End of Work," *Compensation and Benefits Management*, Spring 2000

Klein, James, comments before the Working Group on Phased Retirement ERISA Advisory Council, U.S. Department of Labor, Washington, D.C. July 17, 2000

National Council on Teacher Retirement website: <http://www.nctr.org>

Rajnes, David, "Phased Retirement: Leaving the Labor Force," *EBRI Notes*, September 2001

Scahill, Patricia L., and Jonathan Barry Forman, "Allowing Phased Retirement Helps Both Employees and Employers," *The Actuary*, March 2002

Scahill, Patricia L., and Jonathan Barry Forman, "Protecting Participants and Beneficiaries in a Phased Retirement World" Presented at *Retirement Implications of Demographic and Family Change* Symposium, San Francisco, (Sponsored by the Society of Actuaries, June 2002)

The Segal Company, "The Aging of Aquarius: The Baby Boom Generation Matures," February 2001

Snell, Ronald, "Pensions and Retirement Plan Enactments in 2000 State Legislatures: Final Report," National Conference of State Legislatures, September 26, 2000

Snell, Ronald, "Pensions and Retirement Plan Enactments in 2001 State Legislatures: Final Report," National Conference of State Legislatures, December 11, 2001

U.S. General Accounting Office, "Older Workers: Demographic Trends Pose Challenges for Employers and Workers," November 2001, Report GAO 02-85

Watson Wyatt *Insider*, August 2002

Wisconsin Department of Employee Trust Funds, "Wisconsin Transitional Retirement Study," March 2001