



December 24, 2002

2002-2003

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Washington, DC

**RE: Comments on IRS Notice 2002-43**

Ladies and Gentlemen:

The National Association of State Retirement Administrators ("NASRA") appreciates the opportunity to submit comments to the Treasury Department and the Internal Revenue Service regarding phased retirement arrangements under qualified defined benefit plans. NASRA is a non-profit association comprised of the administrators of the state and statewide retirement systems within all 50 states, the District of Columbia, and the four U.S. territories. These systems cover over 10 million participants, retirees, and beneficiaries and hold over \$1.5 trillion in assets.

NASRA established a Phased Retirement Committee to develop a response to the questions posed in Notice 2002-43. NASRA has adopted six principles on phased retirement that were used to guide the development of this letter. Our comments focus exclusively on state and local governmental pension plans and thus do not address nondiscrimination testing and joint and survivor rules.

Phased retirement is an area of great interest to our plan participants, the boards of trustees of our systems, and the employers participating in our systems. State and local governments must meet the challenge of phased retirement earlier than the private sector, because their workforce tends to be several years older than the private workforce and their wages are typically lower than in private industry. We have concluded that greater flexibility than is presently available is needed to allow plan sponsors to offer a mix of retirement payments and salary payments in the emerging phased retirement environment.

We commend the Treasury Department and the Internal Revenue Service for seeking comments on this subject, as it is neither an easy nor a non-controversial one to resolve. There are multiple viewpoints regarding the many possible approaches to phased retirement, but after careful consideration of input from NASRA members and evaluation of the various points of view presented, we offer the following response.

### **Principles for Phased Retirement**

- 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 pre-retirement 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. These do not include programs that allow a retiree to return to work.**

Greater flexibility is needed in federal guidance and tax laws to allow states and local governments to create programs that address the phased or transitional retirement needs of public employers and their employees. NASRA believes the following factors argue for flexibility in retirement approaches:

- 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. The concentration may be in certain geographic areas, certain professions or positions, or with certain employers.
- Employees are working longer. The long-running trend toward an earlier retirement age (especially a permanent "no-work" retirement) has stopped and may have begun to reverse. However, employers are not legally positioned to increase the retirement eligibility age for present employees.
- Retiree medical costs are increasing at rates that make it necessary for employees to work at least enough hours to maintain group health coverage until they are Medicare eligible. Availability and affordability of health insurance is a major driver of when employees are positioned to move to fully retired status.
- The Social Security retirement age is gradually increasing to age 67, which may motivate workers to further defer their retirement dates.
- A growing consensus exists that the nature of retirement is changing. Many workers no longer wish to experience a sudden end to work, followed by an equally sudden onset of full-time retirement. Instead, many workers wish to ease into retirement, transitioning out of the workforce with a reduced workload and/or the flexibility to work a different schedule.
- Two years ago, Congress approved the elimination of the Social Security earnings test for people age 65 or older, thus freeing older retirees to be gainfully employed and earn as much as they wish without losing Social Security benefits.
- Social Security is increasing the delayed retirement credit that serves as a reward for delaying initial benefit receipt beyond 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/retirement arrangements.
- An increasing number of retirees face financial burdens, requiring them to continue working. The disastrous overall performance of the financial markets for the last two years also has directly affected many members' retirement planning. Losses exceeding 20% of the value of their supplemental deferred compensation accounts and/or tax sheltered annuity accounts by many people have caused changes in projected dates of retirement and type of retirement (with continuing work in some capacity being a growing financial necessity).

**2. Every retirement system is different in design. Thus, IRS activity in the area of phased retirement should allow retirement systems to have such programs.**

Additional flexibility in payout options should be granted to permit variable payouts over the lifetimes of plan participants, including in-service distributions for members who meet early or normal retirement criteria. Currently, minimum distribution rules and premature distribution rules prohibit or discourage this flexibility. Also, the 10% premature distribution penalty should be modified so that the "substantially equal" test would still be met if the payments were made part of a plan's phased retirement program.

**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, the IRS should not adopt any policy that would require retirement systems to assume additional funding obligations.**

NASRA members have differing views regarding in-service distributions. Some systems believe that in-service distributions are inherently counter to the system's purposes. Some of these systems are concerned that if the IRS permits in-service distributions, particularly without requiring a corresponding decrease in workload or a limited return to service requirement, the system could be financially harmed. Other systems believe some limited exceptions would be helpful and would like to see the IRS clarify that if a system elects to do so (but with no mandate to do so), it may allow in-service distributions at such time as a person is eligible for benefits as defined under that system. What NASRA members do agree on is that the IRS should not adopt any policy that would require states to assume additional funding obligations. Time limits on any experiments in the phased retirement arena should also be permitted so that governmental plans are able to sunset them or only use them in conjunction with a window program. Any IRS guidance should not associate the concept of "vesting" with these programs.

- 4. The 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 terms are 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 would serve to recognize that state and local governments have different ways of defining these terms.**

There is strong consensus among NASRA members that the IRS should not attempt to define early or normal retirement age. There is a wide range of retirement criteria in place, and it would be inappropriate, unpopular and counterproductive for the IRS to attempt to develop a standardized definition. Trying to “lock down” standard definitions would be an impediment to state and local government efforts to address employer staffing and experience needs as well as employee financial needs as they transition to retirement. Rather than attempt to create standardized definitions for early or normal retirement age, we believe the IRS should defer to the applicable state or local laws, regulations and policies governing a particular plan

- 5. Distribution of benefit should only be made after an individual is eligible for a retirement benefit or allowance.**

Phased retirement structures should only contemplate distribution of benefits after an individual is eligible for retirement benefits, using whatever age and/or service the plan design requires. NASRA also does not believe it would be appropriate for the IRS to attempt to define the workload reductions that would be required to allow in-service distributions.

- 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.**

Although we realize it is not under the jurisdiction of Treasury or the IRS, the EEOC should be encouraged to review its rules with respect to phased retirement since it is currently not clear how the ADEA should be applied under these circumstances.

### **Current Framework for Retirement**

To facilitate your review of this subject, we thought it might be helpful to provide an overview of how NASRA members’ systems are currently structured. The provisions of most of our members’ systems are either wholly or in significant part established by state legislatures. Virtually all “plan documents” are public record. Those two facts clearly distinguish us from most private sector plans where plan provisions are established by individual employers in the context of ERISA. Public systems generally have hundreds if not thousands of employers (cities, counties, towns, state agencies, public schools, universities, etc.) who are either statutorily mandated into the state system or who may elect to cover their employees in the state system. Regardless of which approach is used (mandated or elective), once in, employers generally must cover all eligible employees, perhaps with some statutory exclusions. According to the US

Census Bureau, in 1999-2000 there were more than 2,200 state and local government employee retirement systems covering fourteen million active employees and five million retirees. Ninety percent of our members participate in defined benefit pension plans. Membership in public pension plans is concentrated in a relatively small number of retirement systems, with the largest seventy-five retirement systems representing more than 80% of all public retirement plan participants. Of these largest systems, the administrators of 56 are NASRA members.

### **Final Observations on Phased Retirement**

The concept of “retirement” and the needs/wants of older workers in retirement are changing. If we, as pension administrators, are to meet those needs with innovative and creative ideas, we cannot be restricted by thinking only in terms of “the way we have always done it.”

Because no two governmental retirement systems are exactly alike, it is critical for federal tax laws and guidance to be structured to allow as much flexibility as possible for state and local governments to be able to address the phased or transitional retirement needs of their employees as they see fit. Any guidance should be permissive, such that systems (and their legislatures) will have the right to develop plan provisions that are the most appropriate for their participants. For instance, public systems vary greatly regarding what constitutes normal retirement age as well return-to-work latitude. Some legislatures have chosen to limit ability to work and receive full pension benefits while others have traditionally been much more flexible. Furthermore, because of specific circumstances related to demographic shifts and critical needs, some are giving consideration to expanding workers’ ability to work and receive all (or some part) of the retirement benefits for which they have qualified. Consequently, no single phased retirement approach would be appropriate for all governmental employers.

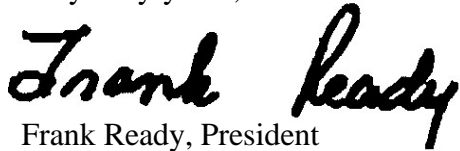
Each state should be able to establish a program that meets its needs and too many restrictions will make this difficult, if not impossible. With the high cost of health insurance and the many budget cuts facing state governments, there may be instances where a state finds that unfettered consideration of phased retirement can work to the advantage of employers and employees. There are also actuarial considerations to take into account when offering post-retirement employment with no clear definition of how long the employment can last, which may result in some states choosing to limit the “phased” period or not offer it at all. Individual states are best positioned to look at the cost implications, the human resource needs, and the “cultural” expectations of such a program. This will also provide an “idea pool” of creative approaches to situations that may be prevalent in several systems.

We also recognize that in some cases there will continue to be a desire to have very limited availability of phased retirement, e.g., only a window of opportunity or only certain types of employees (e.g., teachers). There will invariably be periodic mismatches between the demand for talent and the pool of available talent that can be attracted to employment. It would not be wise to address these periodic mismatches by making changes to the underlying design of a retirement plan that is, for all practical purposes, otherwise achieving broad policy objectives. However, through a change in or clarification to the historical policy regarding partial work, management could be empowered to address short-term personnel needs by tapping the retired population in filling critical positions where temporary workforce shortages exist.

NASRA believes that in some states, the policymakers will decide that they want to allow gradual transitions to retirement. In those states, the policymakers will consider pre-retirement work arrangements designed to permit employees to move from his/her career position to a position of reduced hours, lower compensation, and/or reduced physical or mental stress. NASRA believes that any phased retirement structure should only contemplate distribution of benefits after an individual is eligible for retirement benefits, using whatever age and/or service the plan design requires. As noted earlier, the IRS should not attempt to restrict plan design, but simply defer to the applicable state or local laws, regulations and policies governing a particular plan.

In closing, we thank you for soliciting comments on these very important issues. We applaud the Service's willingness to consider whether federal actions in this area are appropriate, and we would be pleased to meet with you to discuss these issues further. Please feel free to call me at (601) 359-2241; our Phased Retirement Committee Chair, Laurie Hacking at (614) 222-0011; or our director of federal relations, Jeannine Markoe Raymond at (202) 624-1417.

Very truly yours,

A handwritten signature in black ink that reads "Frank Ready". The signature is written in a cursive, slightly slanted style.

Frank Ready, President

National Association of State Retirement Administrators