Phased Retirement for Defined Benefit Plan Participants

Patricia L. Scahill
American United Life Insurance Company®, Pat_Scahill@aul.com

Jonathan Barry Forman
University of Oklahoma, jforman@ou.edu

Follow this and additional works at: http://digitalcommons.unl.edu/joap

Part of the Accounting Commons, Business Administration, Management, and Operations Commons, Corporate Finance Commons, Finance and Financial Management Commons, Insurance Commons, and the Management Sciences and Quantitative Methods Commons

http://digitalcommons.unl.edu/joap/36

This Article is brought to you for free and open access by the Finance Department at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in Journal of Actuarial Practice 1993-2006 by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.
Phased Retirement for Defined Benefit Plan Participants

Patricia L. Scahill* and Jonathan Barry Forman†

Abstract†

The demographic makeup of the U.S. workforce is changing. The population between ages 55 and 64 is projected to increase significantly by 2020, but employment rates for this age group have not been increasing. Employers will likely need to encourage critical employees in this age group to delay retirement. Phased retirement is one tool for delaying retirement, while also not continuing full-time employment, so it can be a compromise for employers and employees.

Both Congress and two administrative agencies have begun to consider changes in pension laws and regulations that would be needed to accommodate phased retirement for employers who sponsor defined benefit plans. This paper discusses some of the impediments in the current legal framework and changes that could be made without diluting participant protections. This paper also discusses aspects in the actuarial calculation of retirement benefits that impact the financial neutrality of a phased retirement program.

Key words and phrases: ERISA, delaying retirement, pension law, actuarial neutrality, financial neutrality, part-time work

*Patricia L. Scahill, FSA, JD, is a plan review consultant at American United Life Insurance Company®.

Ms. Scahill’s address is: American United Life Insurance Company®, One American Square, P.O. Box 368, Indianapolis, Indiana 46206-0368, U.S.A. Internet address: Pat_Scahill@aul.com

†Jonathan Barry Forman, J.D., is a professor of law at the University of Oklahoma.

Mr. Forman’s address is: College of Law, University of Oklahoma, 300 Timberdell Road, Norman, Oklahoma 73019, U.S.A. E-mail: jforman@ou.edu

*The views expressed in this paper are those of the authors and they do not necessarily reflect the views of their employers.
1 Introduction

As America ages, the demographic makeup of the workforce will change. The U.S. Bureau of the Census projects that, between 2000 and 2020, the number of people between ages 55 and 64 will grow 73.5%, going from 24,276,000 in 2000 to 42,107,000 in 2020. At the same time, the population from age 25 to 54 is projected to remain level. From 1995 to 2002, employment rates remained level for men ages 55 to 61 and rose for women ages 55 to 61, as well as for both men and women ages 62 to 64. Labor force participation rates, however, are much lower for both men and women ages 55 to 64 than for those ages 25 to 54. In 2001, 91% of men and 76% of women ages 25 to 54 participated in the labor force compared to 68% of men and 53% of women ages 55 to 64. If the current labor force participation rates continue, the pool of available workers will decline as the population ages. Consequently, employers will need to find ways to retain their productive older workers.

Factors influencing the employment rate among people age 55 and older include economic conditions, Social Security benefits, and the prevalence and design of private pensions (Purcell, 2002). Since the repeal of mandatory retirement, phased, or gradual, retirement is beginning to replace cliff retirement where a person retires from the workforce and does not return. According to Watson Wyatt (1999a, page 2) "phased retirement is any arrangement that enables employees approaching normal retirement age to reduce their work hours and job responsibilities for the purpose of gradually easing into full retirement."

Many older Americans are staying in or re-entering the workforce in part-time and contingent work situations; see Herz (1995), Quinn (1999), and Wiatrowski (2001). Sixteen percent of the companies participating in a 1999 Watson Wyatt survey offered phased retirement programs (Watson Wyatt, 1999b, page 9). According to one estimate, roughly one-third of older workers leave their long-held career jobs and begin new jobs that serve as a bridge to full retirement. In another 1999 Watson Wyatt survey, phased retirement was more prevalent at firms in which workers have an average age of 45 or higher (Watson Wyatt, 1999a, page 3).

---

1The statistics cited above are taken from Purcell (2002).
2Mandatory retirement is still allowed for certain highly compensated employees.
Clearly, both employers and employees are interested in phased retirement, but, unfortunately, the U.S. pension system was not designed with an eye toward phased retirement. Many companies face serious legal impediments to establishing an effective phased retirement program. Congress and the administrative agencies charged with overseeing ERISA are aware of at least some of these obstacles. In 2000, one of the working groups of the Department of Labor's ERISA Advisory Council focused on phased retirement. Representative Earl Pomeroy (D-N.D.) and Senator Charles Grassley (R-Iowa) introduced legislation that would have changed federal pension law to allow qualified retirement plans to provide in-service distributions once an employee reaches age 59 1/2 or 30 years of service. In 2002, the IRS solicited “comments on issues relating to ‘phased retirement’ arrangements under qualified defined benefit plans.”

This paper discusses the impact of phased retirement on benefits provided by a traditional final average pay defined benefit pension plan. It also presents some of the legal, administrative, and public policy concerns raised by phased retirement. An earlier paper by Scahill and Forman (2002) explored in depth the impact of phased retirement on benefit amounts under various payout patterns. They compare common offsets for benefits paid against continued accruals with an actuarially neutral approach that avoids excessive offsets when only part of the benefit is being paid out during phased retirement. That research is not reproduced in this paper.

2 Overview of Phased Retirement

2.1 What Is Phased Retirement?

The definition of retirement is not simple. It is not just the time when an employee stops working and begins receiving retirement benefits. It has become a more complex activity. People often work while receiving retirement benefits. Long-term employees may retire from one career and go on to another career. Some choose to work less—phasing out of their full-time jobs. Other employees leave their career job and work for another employer, usually part time. This job is used to bridge...

---

5 The Phased Retirement and Liberalization Act (S. 2853/H.R. 4837) (2000). The bill was not voted out of committee in either the House or the Senate.
the transition from full-time work to full retirement and is referred to as a bridge job. Bridge jobs are often different from the person's career job, perhaps requiring different skills in a different industry. Current impediments to in-service distributions from defined benefit plans during phased retirement may force workers to use a bridge job as the phased retirement vehicle rather than a reduced work schedule on the career job.

This paper focuses on the type of phased retirement in which an employee works a reduced schedule on the career job prior to full retirement from that job. It does not discuss other retirement arrangements such as bridge jobs.

### 2.2 The Importance of Phased Retirement

Phased retirement is not a new phenomenon. It is expected to increase in importance for the U.S. workforce as the large cohort of baby boomers begins to reach retirement age. The baby boomer generation is often defined as those born from 1946 through 1964. The oldest of the baby boomers have already begun to reach age 55—a common age for early retirement eligibility in defined benefit plans. They will begin reaching age 65 in 2011. With increased longevity and more healthy years, many baby boomers will have an active life well beyond age 65.

EBRI's 2001 Retirement Confidence Survey reported that 26% of retirees say they have worked either full time or part time since they retired (ERBI, 2001, page 1 of "Retirement in America" fact sheet). Not all employees will have other sources of income, such as investment income, to supplement their earned income during phased retirement, so they may need to access at least a portion of their pension as they ease into full retirement. The current U.S. pension system does not facilitate phased retirement, especially for participants in defined benefit plans who want to begin receiving pension benefits prior to normal retirement age while continuing to work. The conflict between part-time work and phased retirement is an example of unintended consequences in U.S. pension law. Legislative and/or regulatory changes that allow employers and workers to structure in-service access to retirement benefits will be necessary if phased retirement is to become an attractive alternative to a significant segment of baby boomers.

### 2.3 Individualized Phased Retirement Arrangements

One advantage of phased retirement is that it allows employees and employers to negotiate individualized part-time work schedules during
phased retirement. One employee may want to gradually decrease the hours worked each year while another employee may prefer to begin with a significant drop in the full-time work schedule and to fully retire after a few years of that reduced schedule. Individualized phased retirement work schedules are no more complicated for the employer to administer than different part-time schedules for workers.

Based on business needs, the employer might designate certain positions as available for part-time hours for phased retirees. In other situations, the employer may want to retain a valuable employee, so it makes business sense to accommodate the employee's desire to ease into retirement with a reduced work schedule. On the other hand, if an employee is only a marginal employee, the employer has little or no motivation to negotiate a special work schedule or transfer the employee to a part-time position. It is legal for an employer to differentiate between employees based on work performance, but it is not legal for an employer to discriminate on the basis of any protected classification, including age.

One possible change in pension regulations, would be to allow payment of partial benefits prior to normal retirement, but the participant must be working a reduced schedule. If the employer refuses a marginal employee’s request to phase into retirement by working a reduced schedule, the employee might claim his or her ERISA rights were violated because the employer’s refusal to allow phased retirement interfered with early access to retirement benefits. The employer should maintain careful documentation about when and why phased retirement working arrangements are or are not permitted in order to be successful in any such legal challenge.

3 Financial Neutrality of Payouts

This discussion of financial neutrality of phased retirement payouts begins with the premise that phased retirement should be beneficial to both the employer and the employee. One way to assess the impact of a phased retirement arrangement is to weigh the cost and benefit of the arrangement. The primary benefit to the employee is flexibility in designing the transition from full-time work to full retirement and being able to work a reduced schedule at the career job rather than being forced to use a bridge job. The primary cost to the employee is reduced income that results from a reduced work schedule. The employee can use personal savings or in-service retirement benefits to help offset the reduction in compensation during phased retirement.
From the employer's perspective, the main benefit of allowing part-time work during phased retirement is retaining a valued employee. The balance between that benefit and any cost of an individualized phased retirement arrangement will help determine whether a particular arrangement makes business sense. The cost, if any, of paying in-service retirement benefits depends on whether those payments prior to normal retirement are subsidized. Other costs the employer might incur are outside the scope of this paper.

The key to financial, or actuarial, neutrality in pension payouts is for the plan to make a full actuarial reduction for early retirement distributions as well as a full actuarial increase for benefits accruing during continued employment after normal retirement. Actuarial assumptions must also be consistent in the calculation of early retirement reductions, delayed retirement increases, and conversion from the normal payout method to optional payout methods to achieve this actuarial neutrality.

If a participant is entitled to a certain monthly lifetime annuity beginning at normal retirement, the benefit is reduced if it commences at an earlier date because the participant will receive more benefit payments. It is common for defined benefit plans to pay actuarially subsidized benefits to participants who retire prior to normal retirement. These subsidized benefits may have been part of a workforce management program that encouraged employees to retire early as a way of creating opportunities for younger workers through turnover. A full actuarial reduction for early commencement and a full actuarial increase for delayed commencement refer to the situation where the actuarial value of the benefit payouts is the same regardless of when

---

7Because the employer is not required to permit a full-time worker to change to a part-time schedule, the employer has no motivation to make phased retirement available to marginal, or even average, workers.
8Subsidized early retirement benefits are discussed below. It is highly unusual for the actuarial adjustment to payments that commence after normal retirement age to be subsidized.
9These other costs could include the cost of benefits such as life or health insurance.
10If a defined benefit plan pays lump sums to phased retirees, this actuarial neutrality may not be possible because of actuarial assumptions currently mandated for lump sum calculations.
11Under a lifetime annuity, benefits are payable until death. Regardless of when payments begin, payments cease upon the participant's death. As a result, the younger the participant is when benefits begin, the more benefit payments will be received during the participant's lifetime.
12These subsidized benefits likely have continued from a prior era of generous pension benefits if they remain in the plan. From the authors' experience, plan sponsors today are no longer adding subsidized early retirement benefits to plans.
they begin. Both subsidized early retirement benefits and subsidized delayed retirement benefits are more valuable than the corresponding benefit commencing at normal retirement. Participants receive more valuable benefits by commencing payments at the age when the subsidy is the highest. As a result, the cost of the benefits to the pension plan is highest when the participant maximizes the value of benefits by timing payments to begin when the subsidy is the highest.

If retirement benefits are financially neutral, there will be no financial impact on the employer if the employee decides to supplement his or her phased retirement income with pension plan distributions. This financial, or actuarial, neutrality is achieved when the present value of the expected pension payments does not change because the employee decides to phase into retirement and begins receiving in-service distributions rather than fully retiring immediately. Actuarial, or financial, neutrality also means that the plan is neither better off nor worse off financially because of the in-service distributions an employee receives during phased retirement.

If a participant terminates under a pension plan and is eligible to begin receiving pension distributions at early retirement, normal retirement, or any time between, the employer does not participate in the participant’s decision of when to begin pension payments. Benefits paid prior to normal retirement may be subsidized, but the employer does not discourage the employee from receiving these distributions. Similarly, once the phased retirement pattern is negotiated, the employee is free to decide when to commence pension distributions within the constraints of the law. If in-service payouts are permitted prior to normal retirement and those benefits are subsidized, the cost of offering the flexibility of phased retirement to employees who are under the normal retirement age will be higher because of the increased cost of the subsidized retirement benefits. On the other hand, if the retirement benefits are not subsidized, there will be no cost to the employer if the employee receives in-service distributions prior to normal retirement.

4 Final Average Pay Benefit Issues

Most defined benefit plans base benefits on compensation, and most of those plans use a variation of final average pay.\textsuperscript{14} For example, the

\textsuperscript{13}As discussed elsewhere in this paper, regulatory and/or legislative changes will be needed for these payments to be available.

\textsuperscript{14}Of the defined benefit plans surveyed by the Bureau of Labor Statistics, 76% used some form of final or final average compensation in their benefit formulas; see \textit{Employee}
plan's benefit formula might be 1% of average pay multiplied by credited service. If a five-year averaging period is used, average pay could be the average of the highest five consecutive compensation amounts or it might use the highest five consecutive compensation amounts of the final ten years.\textsuperscript{15}

Although it is not true in all cases, most employees receive salary increases throughout their working career. As a result, pay in the years immediately preceding retirement would produce the highest average. If the employee begins working a reduced work schedule just before retirement, pay received during the year will be lower than if the employee had continued working full time. Because those final years would produce the highest average if the participant continued working full time, the employee will have a lower final average compensation as a result of phasing into retirement. If the plan defines final average compensation as the average of the highest five compensation amounts during the employee's entire working career, the final average itself will not decline during phased retirement. It will not be as large, however, as it would have been if the final years had been full-time years.

The definition of final average pay clearly has a significant impact on the effect of phased retirement on the retirement benefits payable from a final average pay plan. Internal Revenue Code §401(a)(4) regulations have special provisions for employees working less than full time in a safe-harbor-design plan using final average compensation.\textsuperscript{16} These rules allow the plan to drop years or months in which the participant works fewer than a specified number of hours. These drop-out rules would only help a participant who returns to full-time work prior to retirement.

Because phased retirement should be structured to benefit both the employee and the employer, it seems unfair not to reflect pay increases in final average pay used to determine the benefit amount. To be sure the worker gets the benefit of pay rate increases during phased retirement, the plan could annualize pay during phased retirement years similar to the approach some plans use for any participant who does not work a full-time schedule. From the authors' experience, the most common approach is to annualize pay when the participant receives a

\textsuperscript{15}Plans that integrate benefits with Social Security (i.e., use permitted disparity described in IRC §401(l)) are required to use consecutive compensation amounts in determining final average pay. See §1.401(a)(4)-3(e)(2)(ii)(E).

\textsuperscript{16}§1.401(a)(4)-3(e)(2)(ii)(D).
Scahill and Forman: Phased Retirement

partial year of service when not working a full-time schedule.\textsuperscript{17} If the plan credits a partial year of service for a year in which a participant works fewer than a threshold number of hours, a participant working part time while phasing into retirement would receive a partial year of service.\textsuperscript{18} In order to avoid double prorating, the plan would then annualize compensation for that year.\textsuperscript{19} Other approaches are available to assure the phased retiree receives credit for pay increases while phasing into retirement in the calculation of final average compensation (Scahill and Forman, 2002).

5 Public Policy Issues In IRS Notice 2002–43

In 2002, the Internal Revenue Service and the Treasury Department requested "comments on issues relating to 'phased retirement' arrangements under qualified defined benefit plans.\textsuperscript{20}" The Notice acknowledges that both employees and employers are interested in encouraging older, more experienced workers to remain in the workforce and phased retirement is one approach to offering a smoother transition from full-time work to full retirement.

The Notice raises a concern that allowing earlier access to retirement income could increase the possibility of the person outliving retirement savings. Phased retirement can provide additional time to save prior to full retirement. On the other hand, if the person needs to access retirement savings during phased retirement, phased retirement will begin the payout of those retirement savings sooner. If retirement savings are converted to a lifetime annuity, early distribution will not increase the risk of outliving retirement savings. Early distribution as a lifetime annuity increases the risk of inadequate retirement income because the distribution is reduced for early commencement.\textsuperscript{21}

\textsuperscript{17}The authors have encountered plans sponsored by health care industry employers using this approach.

\textsuperscript{18}Some plans credit a full year of benefit accrual service for a year in which the participant earns 2,000 or more hours and credit a fraction of a year equal to hours worked divided by 2,000 for a year in which the participant works at least 1,000 hours but fewer than 2,000 hours. Many other service crediting options are available.

\textsuperscript{19}If a full-time employee works 2,000 hours and the phased retiree works 1,500 hours, pay for that year for the phased retiree would be annualized by multiplying pay received by 1.333 (2,000 ÷ 1,500).

\textsuperscript{20}Internal Revenue Service Notice 2002-43, 2002-27 IRB 38.

\textsuperscript{21}As discussed above, benefits that begin prior to normal retirement are generally reduced to reflect the fact that the person will receive benefits over a longer period of time. The actuarial reduction is required to maintain actuarial neutrality and not in-
The authors are pleased that the IRS and the Treasury Department are interested in finding ways to encourage employees and employers to find mutually beneficial phased retirement arrangements as well as finding ways to protect retirees from the risk of outliving retirement savings or having inadequate retirement income. The following are some of the specific issues raised in Notice 2002-43:

- The primary purpose of qualified retirement plans is to provide benefits after retirement. Under what circumstances would allowing defined benefit plan participants to begin receiving in-service retirement income distributions prior to normal retirement be consistent with this purpose?

- Should rules allowing in-service distributions consider the extent to which the participant has reduced his or her work schedule?

- If in-service distributions prior to normal retirement are allowed, how should additional benefits that accrue during continued employment be calculated?

  - How should reductions in compensation be addressed?
  - How should early retirement subsidies\(^{22}\) be taken into account?

- How should the definition of uniform benefits under nondiscrimination testing be changed?

- What guidance would be needed concerning qualified joint and survivor annuities and qualified preretirement survivor annuities requirements?

- What guidance should be provided concerning anti-backloading\(^{23}\) and maximum benefit\(^{24}\) limitations?

- How should phased retirement be distinguished from the situation in which an employee terminates retirement and is rehired as a consultant or independent contractor?

\(^{22}\)For the definition of early retirement subsidy, see discussion concerning actuarially neutral benefits in Section 3 above.

\(^{23}\)IRC §411.

\(^{24}\)IRC §415.
6 Is Phased Retirement Good Public Policy?

Workers currently have the option of easing into retirement without changing jobs, but there are pitfalls inherent in the current legal framework if an employer who sponsors a defined benefit plan offers phased retirement, including in-service pension benefits. Is it good public policy to change the law or issue regulations to support phased retirement? On the one hand, one could argue that providing workers with more opportunity to manage the end of their career is good public policy. Rather than forcing employees to change jobs in order to access their retirement benefits, employees would be able to continue their career job at a reduced schedule and receive a portion of their retirement benefits. The law would need to be changed or regulations would need to be issued to make this option a realistic one.

Some may be concerned that employers will force out older workers. Does phased retirement increase the risk that older workers who are not ready to reduce their work schedule will, instead, be forced out altogether? There is nothing inherent in phased retirement that increases the opportunity for age discrimination.

Whether to allow workers who are phasing into retirement access to a full distribution from the retirement plan is another public policy issue. Participants may need access to pension benefits in order to subsidize reduced earnings during phased retirement. As discussed earlier, benefits that commence prior to normal retirement are generally reduced to reflect the fact that they will be paid over a longer period. The periodic lifetime benefit is smaller if payments begin at a younger age. If the full accrued benefit is payable at the beginning of phased retirement, the participant faces a significant risk of inadequate income after full retirement. If the participant subsidizes the reduced pay\(^{25}\) during phased retirement by receiving the full accrued benefit rather than just a portion of the accrued benefit, the employee will have a significant reduction in pension income upon full retirement when earned income stops. On the other hand, if the participant only receives a portion of the accrued benefit during phased retirement, the participant will be able to receive a larger pension distribution upon full retirement when the untapped portion of the accrued benefit becomes payable in addition to the portion payable during phased retirement. This additional pension distribution will almost certainly be less than the income during phased retirement, but it lessens the income reduction upon full retirement.

\(^{25}\)Pay will be reduced during phased retirement because the employee is no longer working a full-time schedule.
In exchange for removing some of the current legal obstacles to a flexible phased retirement program, the government would likely require that phased retirement be available on a nondiscriminatory basis. Employers would be faced with the issue of whether a phased retirement program is retaining primarily highly skilled and effective workers or ones who are no longer effective. Employers who offer early retirement incentive programs face the same type of problem. The solution to this problem does not lie in the particulars of the retirement program, but instead it lies in effective workforce management. Just as employers are not required to employ anyone who wants to work for them, requiring employers to accept an individualized phased retirement program from any employee wanting to phase into retirement would interfere with business management.

The authors believe phased retirement is good public policy as long as the law is changed to facilitate phased retirement programs and protections are put in place to prevent abuse.

7 Basic Legal Considerations

Workers who elect phased retirement and who do not want to begin early distributions from the pension plan are free to take phased retirement under current pension law and regulations.

There are many legal considerations that impact a phased retirement program that seeks to allow participants access to in-service pension benefits prior to normal retirement age. We will discuss some of the major ones that affect defined benefit plans:

- Paying partial retirement benefits before full retirement,
- Offsetting continuing benefit accruals by the value of in-service distributions, and
- In-service distributions before the plan's normal retirement age.

Paying Partial Benefits Before Full Retirement: Although there is nothing specific in ERISA that prohibits defined benefit plans from paying partial benefits, there are a number of obstacles that may make these benefits impractical. For example, an employee taking phased retirement might want to receive 50% of his accrued benefit while working 50% of a full-time work schedule. ERISA and the Internal Revenue Code

---

26See Section 6 above for a discussion of problems caused by paying the full retirement benefit prior to full retirement.
and related regulations refer to commencement of benefits, calculation of accrued benefits, spousal consent, etc. as they apply to the full pension. The statute and related regulations do not discuss paying a portion of the benefit beginning at one date and then paying the full benefit at a later date.

One question is how to increase the remaining portion of the accrued benefit for the period of phased retirement after normal retirement age.\(^\text{27}\) If the benefit were not actuarially increased, the participant would need to be given a suspension of benefits notice for the portion of the benefit for which payment is delayed. If the benefit were actuarially increased, the employer would need guidance on how the increase would be calculated. Would it apply to the full accrued benefit or to only the portion not in pay status? The actuarial increase must apply to the entire accrued benefit in order to achieve actuarial neutrality as defined in this paper. See Scahill and Forman (2002) for a detailed demonstration of one method for achieving actuarial neutrality.

**Offsetting Continued Accruals for Value of In-Service Distributions:** ERISA and the Internal Revenue Code prohibit the discontinuance of benefit accruals or a reduction in the rate of benefit accrual because of the attainment of any age.\(^\text{28}\) Proposed regulation §1.411(b)-2 provides details on the calculation of the accrued benefit after normal retirement age if in-service benefits are being paid out, but it only pertains to continued benefit accruals beyond normal retirement age.\(^\text{29}\)

The challenge for sponsors who want to design a balanced phased retirement program is how to offset for partial annuity distributions. If the entire additional benefit accrual were offset by the annuity value of the benefits paid, it is likely that no further benefits would accrue after partial distributions commence. The increase in the benefit ultimately paid out at full retirement over the benefit payable at the beginning of phased retirement might only be the elimination of the early retirement reduction. See Scahill and Forman (2002) for a detailed demonstration of various offset alternatives.

There are alternative ways to design the offset if the law and/or regulations accommodate these alternatives. If only 50% of the accrued benefit is being paid out prior to full retirement, the offset might apply only to half of the additional benefit accrual. As a result, the participant would continue to accrue at least 50% of what would have been accrued if no distributions had been received. This approach achieves actuarial

\(^{27}\)Both the DOL and IRS have specific rules that apply to benefits that are not paid out while an employee continues working after normal retirement.

\(^{28}\)IRC §411(b)(1)(H) and ERISA §204(b)(1)(H).

\(^{29}\)See Example 3 of §1.411(b)-2 for a detailed discussion of these calculations.
neutrality. If the plan uses a full actuarial reduction before normal retirement and a full actuarial increase after normal retirement, the plan does not experience an actuarial gain or loss as a result of paying in-service benefits prior to full retirement.

In-Service Distributions Before Normal Retirement Age: Under current law, a defined benefit plan cannot make in-service distributions before the plan's normal retirement age. Many defined benefit plans use age 65 as the normal retirement age. Employees who want to begin phased retirement before the plan's normal retirement age are not able to use pension benefits to supplement earned income during phased retirement. Two-thirds of the companies participating in the Watson Wyatt phased retirement survey favor eliminating the restrictions on paying in-service distributions before normal retirement as a way to facilitate phased retirement (Watson Wyatt, 1999b, page 3).

Participants who want to maintain their prior standard of living during phased retirement will likely need personal savings, in addition to access to a portion of their retirement income, to supplement their pay during phased retirement. As discussed earlier, it does not seem to be good public policy to allow access to the full retirement benefit while the participant phases into retirement by working a reduced schedule. Pension benefits will not be sufficient to replace the reduction in compensation during phased retirement. Employees already face the need to have personal savings available during retirement to maintain their pre-retirement standard of living because Social Security and the employer's pension benefit rarely combine to replace 100% of the person's income just prior to retirement. The need for personal savings to use during phased retirement is no different.

8 Impact of Phased Retirement

8.1 On Participant Protections

One of the purposes of ERISA was to provide protection to participants. Some of the areas of protection could be impacted by phased retirement.

30Treas. Reg. §1.401-1(b)(1)(i) states “[a] retirement plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of ... benefits to his employees ... after retirement.” In PLR 8137048, the IRS applied this regulation and concluded that an employee may not receive a distribution from a pension plan before normal retirement while still an active employee.
Disclosure: Effective communication about the plan lets participants understand and take advantage of the benefits offered—it is one of ERISA’s participant protections. Plan sponsors will be challenged to provide understandable information about phased retirement because of the many choices available to the participant. Additional communication material may be needed to explain phased retirement options. The complexity of the communication materials depends on the flexibility of the phased retirement options available to participants. Because phased retirement is an individual arrangement, the communications will need to be tailored to the participant’s particular situation. It will be important to disclose the impact, if any, of reduced pay and credited service on the ultimate retirement benefit. The participant also needs to understand the impact of in-service distributions on the ultimate annuity amount. Helping the participant assess the relative value of various options will help the participant make the best personal choice.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 enhanced the notice requirements for plans reducing the rate of future benefit accruals. Although these requirements will not apply to phased retirement, they provide useful guidance on the types of communication that could be helpful to employees considering phased retirement. Under the EGTRRA disclosure rules, the average participant should be able to understand the communication, and it must give enough information to explain the impact of the provision on the participant.

Software that allows participants to model their benefits under various phased retirement scenarios can be helpful for participants who are comfortable using these tools. In other situations, the sponsor could use a workbook or a series of benefit exhibits to help participants understand the effect of phased retirement on their retirement benefits.

Benefit Accrual Rules: The benefit accrual rules look at the rate of benefit accrual throughout the full employment period. Their basic purpose is to prevent backloading of benefits, and the demonstration

---

31 Examples of some of the choices are how much to reduce the full-time work schedule, whether (or when) to commence retirement plan distributions, and the payment method for those distributions.


33 I.R.C. §419b); ERISA §204.

34 Backloading refers to benefit accruals that increase steeply either as service increases or after a certain number of years of service. For example, a benefit formula providing 0.25% of average pay for each of the first 20 years of service and 2% of pay for each of the next 5 years of service would be considered a back-loaded formula. After 25 years of service, 5% of average pay would have been earned during the first 20 years
of compliance of the benefit formula with the rules is typically based on a full-time employee. As a result, a plan that allows phased retirement should not have problems satisfying one of the accrual rules. Participants will continue earning benefit accrual service as long as they work the required number of hours, assuming the plan uses hours to credit service.\footnote{Plans that use elapsed time for service credits will credit a full year of service for each full year during phased retirement. Plans requiring a certain number of hours for a year of service may credit less than a year of service during phased retirement, depending on the hours actually worked.}

**Nondiscrimination Protection:**\footnote{I.R.C. §401(a)(4).} The mechanical nondiscrimination rules can create problems for employers who try to accommodate employees who want to phase into retirement. The 2000 ERISA Advisory Council’s Working Group on Phased Retirement recommended the following nondiscrimination test alternatives to the Secretary of Labor:

- Permit a facts and circumstances test for phased retirement provisions in a pension plan, as an alternative to passing the mechanical nondiscrimination test.
- Develop safe harbors and/or special rules addressed to phased retirement programs that accommodate their special characteristics.\footnote{See page 3 of the reference in footnote 4.}

### 8.2 On Spousal Protections

The primary areas of spousal protection are the following ERISA requirements (Forman, 2000):

- Spousal consent for certain forms of benefit payment, and
- Amount of qualified surviving spouse annuity (QJSA)\footnote{A qualified joint and surviving spouse annuity (QJSA), as defined in §417(b), is an annuity that pays the surviving spouse no less than 50\% and no more than 100\% of the amount payable while the participant is living and receiving benefits.} and qualified pre-retirement spousal death benefit (QPSA).

**Spousal Consent:** Spousal consent is only an effective protection if the spouse understands the impact of waiving the qualified joint and survivor annuity (QJSA). If the participant works a reduced schedule of employment and 10\% of average pay would have been earned during the final five years of employment. This formula backloads the benefit accrual because it provides a much larger value for later years of service.
during phased retirement, but he or she does not elect to receive any pension benefits before full retirement, spousal consent will not be affected by phased retirement.

If the participant elects to receive benefits during phased retirement, spousal consent would be required if the benefit were not payable in the form of a QJSA when phased retirement benefits begin. Upon full retirement, the original spousal consent would continue to apply to the additional benefit that will be payable unless the plan requires a new spousal consent. The requirement of multiple spousal consents may be confusing to the spouse, so the plan sponsor should try to ensure that the spouse understands that the initial consent only applies to the initial partial benefit.

Amount of Qualified Joint Survivor Annuity (QJSA) and Qualified Preretirement Survivor Annuity (QPSA): If participants elect phased retirement in a final average pay plan and the final average pay decreases during phased retirement, the ultimate retirement benefit may be lower than if the participant continued working full time. Therefore, the QJSA as well as the QPSA will be lower as a result of lower annual pay during phased retirement.

Although it is not reasonable to expect the spouse to have the right to consent to a reduced work schedule as part of phased retirement, there is an erosion of some of the spousal protections on account of phased retirement.

9 Deferred Retirement Option Plans (DROPs)

Some public sector retirement plans include deferred retirement option plans (DROPs) that allow workers to continue working and have retirement benefits deposited into a separate account that earns interest. The participant receives the value of the DROP account upon full retirement, generally no more than five years after electing to have benefits deposited into the DROP.

DROPs can be structured to apply once the participant has become eligible for unreduced benefits or to apply also to participants who are eligible for an early retirement subsidy. If the DROP is only available to participants who are eligible for unreduced benefits, the DROP effectively lets the participant take the unreduced benefit without having to retire. In this situation, DROPs would be attractive to participants.

who do not need retirement income as a supplement during phased retirement.

If the DROP applies to participants eligible for subsidized early retirement benefits, it allows the participant to receive that subsidy without having to terminate employment. The subsidized benefit is deposited in the DROP and earns interest until retirement. At retirement, the subsidized early retirement benefit would be the monthly benefit payable to the participant. As long as the earnings on the DROP are sufficient to protect the value of the early retirement subsidy, the participant will end up with more valuable lifetime benefits because the participant will receive the value of the early retirement subsidy. Even though the benefits paid out after retirement are reduced as if the participant had retired early, the value of the DROP could more than compensate for the cost of the early retirement reduction in the lifetime benefit.

10 Conclusion

Phased retirement provides employees with important options for managing the end of their working careers. It provides employers with a way to retain valuable knowledge workers who no longer want to work full time. It is important for U.S. pension law and regulations to be modified to facilitate phased retirement, but those changes should include safeguards to protect workers and spouses as they make decisions that will have a lifetime financial impact.

References


Scahill and Forman: Phased Retirement


