



Employees Seek Legal Shelter for “Phased Retirement” Plans

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Forget early retirement incentives. Employers concerned with a shrinking labor pool are now trying to keep workers on the job for as long as possible. In addition, many workers eyeing retirement in their early 60s are increasingly wary of the financial and benefit implications of leaving work entirely. As a result, there is a growing trend toward the middle ground - a period of partial work and partial retirement, where working hours may be reduced, but productive work continues. Employers and employees alike are interested in such “phased retirement” programs.

But the law doesn’t make such programs easy. Historically, pension benefits can be legally paid only when a person stops working entirely. But the rules are changing and the Internal Revenue Service has proposed regulations that make phased retirement more plausible in handling retirement plans. This article discusses the proposed phased retirement rules applicable to pension plans, as well as the issues that are likely to arise regarding health and welfare plans and traditional employment law.

Impact on Retirement Plans

Phased retirement allows employees to transition into retirement by reducing hours and job responsibilities, usually prior to age 65. As hours are reduced, pay is reduced, and many employees thus wish to supplement their income by turning to their employer-sponsored retirement plan.

Tax rules allow employees to make withdrawals from 401(k) plans after age 59 ½, even if the employee continues to work. Employer contributions, such as matching contributions, may be distributed even earlier. However, IRS rules have historically prohibited payments from pension plans prior to age 65, including both defined benefit plans (including cash balance plans) and money purchase pension plans. This puts a natural source of supplemental income off-limits.

Recently, the IRS issued proposed rules that would accommodate phased retirement programs and would allow pension distributions to start while an employee remains at work. But it’s not a free-for-all. A phased retirement program must be carefully structured to fit within the proposed rules. The primary concern of the IRS is that the retirement plan remain a retirement vehicle and provide meaningful benefits throughout the retirement period. The phased retirement program cannot be used in a way that drains retirement benefits for non-retirement purposes. As a result, the rules require that:

- The early payments must be pursuant to a bona-fide phased retirement program, which is:
 - In writing.
 - Available to a nondiscriminatory group of employees.
 - Limited to employees who have attained age 59-1/2 (older age is permitted, and service conditions can also be imposed).
 - Voluntary.
 - Limited to employees who are reasonably expected to reduce hours by 20% or more (written agreement to that effect is advisable).
 - Limited to non-“key” employees. A “key” employee, very generally, is any officer who makes more than \$135,000.
- Phased retirement benefits cannot be paid in a lump-sum (level annuity pay-out generally is expected).
- Phased retirement benefits are a pro-rata portion of full accrued benefit - for example, if the work schedule is reduced to 60% of a full-time schedule, the phase retirement benefit can be 40% of the accrued benefit (to account for the 40% drop in hours).
- While the employee is drawing a phased retirement benefit, the employee also must be accruing an additional benefit in the same manner as if he or she was a full-time employee, except that service credit can be pro-rated for less than a full-time schedule. (Compensation must be imputed at a full-time schedule.)
- When employee fully retires, the accrued benefit is offset by the phased retirement benefit and the net benefit is paid in addition to phased retirement benefit.
- Annual review of the employee’s actual work hours is required, with a reduction made to the phased retirement benefit if the employee has materially higher hours than the reduced time schedule. (If agreement is reached to increase hours, prompt adjustment is required.)

These phased retirement rules are not effective yet, so don’t jump the gun. But the IRS is working on finalizing the regulations. It is not too early to begin analyzing phased retirement options.

Impact on Welfare Plans

Legal issues associated with phased retirement aren’t limited to retirement plans. Benefits such as health insurance, life insurance, and disability coverage are also likely to be affected.

Employees who move to part-time status will often lose benefits and find them difficult to replace. For example, health insurance continuation coverage through COBRA is expensive and limited to 18 months. Individual plans are often prohibitively expensive or unavailable, depending on the health status of the employee or his or her dependents.

As a result, employers will likely want to offer continued health, disability, and life insurance benefits to employees participating in phased retirement programs but not to other part-time workers. Will this pass muster?

While there may not be legal obstacles to offering insured coverage to a limited group of part-timers, employers will want to discuss changes with its insurance carriers. Continuing coverage for workers who would otherwise be retired and “off the books” may change the demographics of the pool and therefore increase costs. Also, many disability and life insurance policies cut off or limit coverage at age 65, so this could be an issue if there are older retirees in the “phased retiree” group.

Employers with self-funded health plans may face additional obstacles. To obtain the tax benefits of self-funded plans, such plans can’t discriminate in favor of “highly compensated” individuals, who are likely to be among the participants in any phased retirement plan. Similar rules apply to cafeteria plans and group term life insurance plans.

Depending on their demographics and risk tolerance, many employers may be able to structure programs which will not violate these rules. Alternatives may include purchasing insurance coverage separately for any highly compensated individuals in the phased retiree group, either individually or as part of a small group; or paying phased retirees who are highly compensated additional income to purchase supplemental benefits.

Unlike IRS proposed rules regarding retirement plans for phased retirement, there are no proposals yet to address health and welfare benefits. However, there is likely to be growing pressure for regulatory or legislative relief. The IRS could issue guidance providing an exception from the various discrimination rules for “phased retirees.” Other proposals suggested by commentators include allowing individuals to purchase Medicare between age 55 and age 65 at a rate competitive with group insurance policies providing similar benefits, and without consideration of insurability and pre-existing conditions; and extending the COBRA period for employees losing coverage after age 55.

Employment Law Issues

Will phased retirement programs cause discrimination issues for employers under traditional employment law, such as the Age Discrimination in Employment Act (ADEA)? Legal questions like that remain in a gray area, depending on how employers ultimately implement their programs.

Presumably, most employers will want discretion to accept or reject individual employees interested in participating in a phased retirement program, because participation will depend in part on whether the employer can structure part-time work for the participants. However, the greater the discretion to turn down individuals, the more likely that those decisions will be challenged as being tainted by unlawful discrimination.

The ADEA generally prohibits employment discrimination based on age, including in employee benefits. Exceptions exist under the ADEA for certain employee benefit programs, including retirement plans, where the plans contain age-based criteria that are designed to facilitate and accomplish the fair treatment of older workers. However, state and local discrimination laws often do not contain the same benefit plan exceptions contained in the ADEA and, in fact, protect against “reverse age discrimination” where older workers are treated more favorably than younger workers. An open question is whether the preemption principles of ERISA, which allow employee benefit plans to operate without regard to differing state and local laws, will apply to phased retirement programs where the employer retains broad discretion over who will be allowed to participate. Is the phased retirement program a bona fide “employee benefit plan”

within the meaning of ERISA and the ADEA?

Amendments to the ADEA (and preempting application of similar state and local laws) may be required to confirm that such plans are acceptable.

Conclusion

As is usually the case, the law is slow to catch up with changing social and economic trends. Phased retirement is a new concept emerging out of demographic patterns and changes in lifestyle. While employers and employees alike will be pushing for greater flexibility to implement such plans to suit the needs of businesses and individuals, the legal roadblocks need to be carefully addressed. Stay tuned for the next phase.

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