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Phased Retirement

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Summary: Traditional retirement used to mean going from full employment to no employment. Now, many people are seeking alternatives, such as reduced workload in current positions, part-time employment or alternative careers. At the same time, employers are looking for ways to retain experienced employees. All of these trends have a significant impact on the delivery of retirement benefits. Speakers review current trends in phased and partial retirement, benefit design issues surrounding phased retirement and deferred retirement option programs (DROPs).

MR. JOHN KALNBERG: I feel a vested interest here. I'd say in 25 months, I'll be eligible to retire. This whole concept of bridge jobs starts to sound real interesting. And I notice I'm not the only person in the room with gray hair.

All of you are here I'm sure for the benefits of your clients and your participants, but I know in any good actuarial session like this, there's also a bunch of people attending out of blatant self-interest.

The Society has put together a great document about post-retirement risk. It's the result of the Postretirement Needs and Risks Task Force, and I think it's really helpful. So if you haven't gotten it, you should make a point of getting it. It gives you a good framework with which to start conversations with clients. There are the typical issues, but there are also things in here that people might not think about. People are starting to play with benefit formulas and switch between defined benefit and defined contribution plans as they look at health benefits. I think this is a

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Note: The chart(s) referred to in the text can be found at the end of the manuscript.

really helpful thing to use to just start a dialogue.
From what I've heard, they have a bunch of copies at the Society, and they're open to people calling them up or sending them e-mails and getting more copies if you want more copies. Now, Valerie is going to speak to us about phased retirement.

MS. VALERIE PAGANELLI: And hopefully there will be a fair amount of questions, too, because that always makes it interesting for all of us.

I've had the pleasure of presenting on the topic of phased retirement probably 20-30 times over the past three years, so I need you to keep it interesting for me as well and to continue to build on the concepts that are already out there as to the evolution of defining retirement. In large part, we are the profession that is going to define retirement, phased retirement, partial retirement, transitional retirement—whatever the code words end up being.

I've sat in some of the sessions in the past day or so that talked about the marketplace in general, and the marketplace from an economic standpoint has a lot of indexes that affect what we do and affect when people select to retire and how effective retirement programs are.

One index that we don't have on the economic indicators is retirement, but the retirement age is likely to increase. We don't see it in a lot of the statistics we look at today, because we're looking at when people exit an organization and take retirement from their pension programs. But many people continue in employment after retirement from a pension program, so our statistics aren't necessarily what they truly are, nor are they what we might see in the future.

What Shapes Retirement Today?
What are some of the things that we are seeing as shaping retirement today? We know that the baby boomers are aging, so as a workforce in total, we are older and getting older—and we won't be getting younger.

We have a shrinking labor pool—demographics that many of you are already familiar with show that there aren't as many younger workers coming into the labor pool as there are older workers exiting the labor pool, so there's an overall shrinkage.

Research indicates that that shrinkage, if we are to maintain the type of gross national product growth that we've experienced in the recent 10-20 years, our labor pool would need to actually grow as opposed to shrink to maintain that GDP. So we're looking at areas that involve extending the working lifetime of the existing labor, which is where phased retirement comes in. We are also looking at more women being able to enter the work force to fill that gap.

You have immigration and exportation of jobs in technology. I have not seen one piece of research that says that when we combine all those together, we still have the opportunity to get where forecasts suggest we need to be to experience GDP growth.

Phased Retirement Overview

Phased retirement, from an individual's perspective—or retirement in general—is the need for financial security. We've really created a system over time that says, "I will have adequate funds in retirement through the three-legged stool: personal savings, Social Security and a pension program. Those three-legged stools are very uneven depending on which organization you've invested your career in or how you've invested your career over time, so financial security isn't as straightforward as it needs to be.

Increased life expectancy goes with the desire to remain active. Because of increased life expectancies, there's better health and a greater desire to remain active. So this typical age of 65, as we've known it for decades, is really not the end point for people's active contributions to their working careers.

Chart 1 is probably familiar to everyone in the room who deals closely with pensions. It illustrates what I mentioned earlier—the change and shift in our workforce. The green bars show the percentage of the workforce in those age cohorts back in 1996, and the blue bars are the forecast of where those cohorts are going to fall in 2006. I've circled the over age 45 group, because you can see where the groups are dramatically increasing by virtue of the 25-34 age brackets significantly decreasing. It's the baby boomers moving through the demographics.

Another way of looking at these same statistics is saying, "How, as a percentage of workforce, are the age cohorts changing over time?" I've really highlighted the younger and older generations to indicate that we are expecting change in the number of workers age 55-64 and who are thus retirement eligible. We are seeing replacement growth of only four percentage points in the younger cohorts. If we anticipate 30-50 percent of our workforce being eligible to retire in the next 10 years, we've got a gap coming in right behind them.

What's Happening to Retirees

As far as what's happening to retirees today from what research is out there and surveys that have been done, we find that many retirees are working in bridge jobs. I think the most official definition, if there is one, of a bridge job is someone who leaves their career job, takes a retirement, a pension, and then goes to work somewhere else, part-time, full-time, but not necessarily in the same profession that their career was in. Nor was it with the employer that they spent their career with.

Many move to self–employment. Many pensioners—you can see 75 percent—of male pensioners in their early 50s, are, in fact, still working. I think that statistic is an indication of the number of early retirement incentive programs that have taken place through the '90s. For economic reasons or because of the desire to continue working, that cohort is still very much active in the labor force.

What we also see is, because employers aren't necessarily set up to create an opportunity for phased retirement, people are creating that opportunity themselves. Many of the employers we work with are seeing their retirees going to work for the competition, where they can take their skill set and put it into play most effectively with another organizations. Not that that's the only scenario that we're seeing, but it is definitely one that many employers are concerned about.

Phased Retirement Defined

The definition of phased retirement that has evolved for me is, "To introduce in stages the departure from one's primary occupation or active working life, while maintaining an appropriate income level."

This can mean any number of things. Some people in the room and some research would suggest phased retirement has a bit of a more narrow focus than this, that it's continued employment and gradually going to full retirement over time but staying with their existing employer. I view phased retirement as being anything that continues the working lifetime of each and every individual.

One question that gets posed to me a lot is, "How important is this today?" We talk about the demographics; we talk about the need for extending working lifetimes. But many organizations, because of the demographics of their own employee population, aren't necessarily feeling the pressures that the demographics would suggest. Other organizations are.

I would say the last couple of years have been somewhat of a quiet period. Some of what I'm going to show you stems from survey work that was done in 1999 and 2000, when this was very much front of mind. The events of 2000, 2001 and 2002, from an economic standpoint, and other issues have kind of set it aside as far as being a live topic.

I've used as a gauge the number of times I get calls from reporters or clients or associations that speak on the topic as being the gauge as to how interested people are on the topic. And I will say for 2001 and part way through 2002, it was really a quiet period for phased retirement; it has really turned back up, I would say in the last nine months. I think the demographics are going to continue to press us.

Phased Retirement in Action

What we found along the way is that phased retirement really is a work in progress for a number of reasons, some of which we'll touch on. The arrangements are really evolving, and some of that is because of the pressure of the demographics within an organization, and some of it is because of restrictive regulations and how a phased retirement program can be put in place. So generally what we found is, there's ad hoc and informal, very individual-focused types of arrangements, which can be risky. At what point do a series of individual arrangements become a program for which there need to be additional rules that an employer considers?

Most of what I would call formalized phased retirement programs are most prevalent in the public sector, and I don't know how many people in the room operate within that arena, but there have been programs in place there for well over a decade that have helped to facilitate the exit of workers in the public sector.

What we've also noticed by virtue of surveys and talking with employers is that many arrangements are put in place for completely other reasons and weren't designed to be phased retirement and actually have come to be used for that purpose. A number of organizations have looked at the programs that they have with the idea of determining whether phased retirement could fit into their organization and have discovered any number of things that they already do that complement phased retirement, but they aren't advertising them as such. So it's a matter of packaging and communicating some of those.

Many organizations you may be familiar with actually rehire their own retirees after a waiting period, and this is where the debate on the definition of a bona fide retirement comes into play. Bona fide retirement, although mentioned within statutes, doesn't ever get fully defined, so different employers have taken different stances as to how much of a waiting period is sufficient for there to have been a bona fide retirement before you can rehire your retirees and treat them like new employees as opposed to a retiree.

One of the other catches in that bona fide retirement is that there's no discussion ahead of time that says, "OK, you retire, leave for a few months and then show up on Dec. 12 and we'll put you back on the payroll." There's no guidance on that, but it is clear that it can't be a prearranged agreement. Generally we found that un-retirement is the most common approach. So I as an individual take the initiative to retire and then re-employ myself independently of the opportunities my employer provides.

Why Go Through Phased Retirement?

In the research that we've done identifying why employees look for phased retirement, health very rarely is the reason. There's been some other supporting research that says those who retire the earliest are often more inclined to be retiring for health reasons. However, the longer someone stays in the workforce, when they ultimately exit the workforce, it's often times not because of health reasons but more of a voluntary choice.

Many employees look for some more leisure time. They don't want full-time leisure time, but they do want more leisure time than perhaps what a full-time career allows.

Caregiving, primarily by women has been found to be a reason—caregiving both for elder care and child care, perhaps grandchildren or great-grandchildren. So in providing flexibility, it may not be through structured programs but more soft benefits that allow people the flexibility in their schedules.

Employees are looking for part-time commitment. I can't recall the exact statistic, but those who go back to work after retirement generally are working in the 60 percent of full-time range, so it's not 20 percent, it's not 40 percent; it's well within the boundaries of what is considered employment.

When I think of benefits not available economically unless they're employed, I think mostly it's health care benefits in today's environment. It's very expensive to get individual medical benefits, so many employees would choose whether, even independent of what might be happening with retirement benefits, access to health care benefits is a primary driver.

Why Do Employers Choose Phased Retirement?

On the flip side, why do employers offer phased retirement or look at offering phased retirement? The primary reason is to retain skilled workers, and that gets after the shift of the demographics. And that's the older cohorts, the ones with the long-term experiences; they need to transition that to the next generation.

Some employers look at it as an opportunity to continue their relationships with their employees. They have a retirement-friendly environment, or they just have the kind of culture where they want to offer the flexibility for their employees to retire gradually.

Facilitating and training of new workers: No one was really putting their pen to paper to say, "We would do something in a phased retirement program to cut our early retirement costs." It really wasn't so much of a cost issue. As I've read through a lot of other people's papers and research and comments to the IRS, it's been interesting to note that many papers are saying, "We want this to be cost-neutral. If phased retirement becomes more prevalent, and there's a structure around it through IRS guidance, we would like for it to become cost-neutral."

I would challenge that a little bit, if not a lot, depending on the organization. Some organizations may very well choose to throw a lot of money at a phased retirement program to retain a certain cohort of employees, so it may not be a cost-neutral proposition at all but some sort of an incentive employers are willing to pay to keep workers.

Ways to Phase

We talked a little bit about the ways to phase. One is reducing your workload, and sometimes in stages—maybe going from 100 percent to 80 percent to 60 percent of full-time over a staged period of time.

Changes in responsibility: The ad-hoc individual phased retirement arrangements are ones in which the specific career that the employee has been in has been very demanding, whether it be travel or hours or just the intensity of the physical nature of the job. So you can have changes in responsibilities, such as getting the standard in the same organization.

We talked about early retiring and then rehiring, needing to do that carefully because of the bona fide retirement requirements. But there's also the debate of whether they can continue to receive pension benefits, and we'll get into that more fully.

Then you have rehiring as a consultant. There's a fair amount of this going on. There is a lot of scrutiny being placed on some organizations, and there's been a fair amount of press around some of those organizations that have done this in a large-scale way, where they have a number of independent contractors who aren't earning benefits, but quite frankly, they aren't the decision makers on how they spend their time when they come into work every day. The legal side of it, when they look at it, says a contractor or a consultant has the opportunity to govern their own schedules and how they execute on their jobs. There is a little bit of a difference there.

What's to Gain?

I'd like to speculate what the companies would gain by putting in a phased retirement program. We talked about knowledge retention.

The second reason is lower hiring and retention costs. I also list that as one of the hurdles or items that preclude phased retirement programs, because in theory, one would want to believe that a phased retirement program, as you extend the working lifetime of existing employees, means that you don't have recruiting and training costs to replace that worker. But it's rare to have an organization have the exact metrics to be able to do that—the cost-benefit analysis of how much you're spending to retain a worker as compared to how much it costs to acquire a new worker.

Preservation of culture and values: This is one that I don't think most organizations place as much emphasis on as they might. But really, in lieu of hiring new people either mid-career or early career, and having to indoctrinate them into your organization—how it works, what its culture is, how to work within the organization—you really retain that as you retain people through phased retirement. I will say it could work against some organizations that are trying to shift culture for business reasons; therefore, some of the longstanding employees may not give the same momentum as new hires would.

I firmly believe that through phased retirement programs, for organizations in which phased retirement programs add value because of demographics and other criteria, really do create a competitive advantage for themselves. There's also a broader economic advantage if we envision the costs and inefficiencies associated with people leaving current employment to go elsewhere. Productivity is lost when someone is learning a new position or learning a new organization compared to staying within the same organization.

Employee Incentives

As far as what the employee gains , we talked a lot about the first couple of bullet items, but the last few are really at the crux of what we'll talk about as we go forward.

Employees who want the phased retirement are really limited in some respects financially if they don't have the opportunity to supplement their retirement with ongoing income. There are also a number of soft issues that have come out through survey work that suggest it's not just the financial security that's being sought but the opportunities to continue to have a forum for socializing and adding value and a feeling of worth.

Trends

Watson Wyatt did a survey in 1999 in which about 45 percent of organizations indicated that they expected phased retirement arrangements to become more prevalent in their organizations in the next five years. There was somewhat of a hiatus in the interest of and in the momentum of phased retirement programs for a couple of years, so I would suggest that five years probably isn't the right duration.

Looking at it today, you'll probably see some momentum in the 2010 range or earlier, but maybe not quite as soon as we otherwise envisioned. There were a fair number of organizations in the survey group that indicated they anticipated heavy interest or moderate interest in implementing these programs.

I always like to check the audience from the standpoint of phased retirement momentum by asking the question, "How many people know a phased retiree today?" Six. How many people are phased retirees today?" There's always one. I love it.

How many people envision for themselves, in their own career, being a phased retiree at some point? Not as many as I would have thought. How many people work for an organization that is phased-retirement friendly? A few. That's probably the biggest cohort I've seen on phased retirement-friendly organizations.

Although there's interest on both the employer's side and the employee side, I find it fascinating that the momentum is much heavier on the employee side, yet the employer side has not really responded to that so much. I think it's because among the people that raised their hands saying they want to be a phased retiree someday, there are a lot of people who are maybe 15, 20 years from that date. So I envision that by the time those individuals are nearing retirement, we'll see a little bit more flexibility.

Right now, the holdup seems to be restrictive regulations, which we'll talk about. In my opinion, we need to let go of this historic practice, if you will, and recognize that age 65 is no longer a magical number and that it's a very individual decision.

Social Security obviously has its landmark ages that it considers primary income, as well as Medicare. But those dates, as we've seen, are not anchored in stone, so anticipate those to continue to change.

Culture Shock
Earlier I talked about company culture and succession planning as being an advantage to some organizations. But for some organizations, even though it might be an advantage to them, their culture really isn't set up to accommodate phased retirement. It may be that they're interested in making individual arrangements with someone, but then that someone goes out into the organization and begins their phased retirement, and they may not be particularly well-received, depending on what they're trying to do during that phased retirement. So many organizations need to address the cultural aspects of phased retirement.

We talked about being able to measure turnover and recruitment so you have a realistic metric as to whether or not investing in phased retirement programs for your organization really does add a monetary value as well. I'm going to get into some of the actual benefits programs and some tweaks that either are available today or that might be helpful in the future.

Defined Benefit Plans
When starting a defined benefit plan, you're probably familiar with the concept that in-service distributions prior to retirement are not deemed allowable within defined benefit pension plans, primarily because the view of the regulators is that those monies are intended for retirement, at full retirement. Their intent is not for them to be available for disposable income while you're still working.

Higher Retirement Ages. Now, the key in that is there are no in-service distributions before normal retirement age. Many defined benefit plans define normal retirement age as 65; some are tied into Social Security normal retirement age, so they vary from 65 to 67. Nonetheless, that is the threshold that restricts in-service distribution. An employer could choose to lower that age. There are some implications to that from a cost standpoint if the underlying benefit formula doesn't change and you just offer full retirement at a younger age. We haven't seen a whole lot of that going on, although it is always on the table.

Index Final Average Pay. For a lot of the defined benefit plans, the traditional defined benefit plans—not so much hybrid, unless you're talking about pension equity plans—have a final average pay component to them. As you go into phased retirement, you need to tweak how you adjust final average pay. If you've got a final three-year average pay formula and your final three years are as a phased retiree working 60 percent time, you really don't want those to be the three years that affect your ultimate pension benefits.

There are a number of theories out there that suggest some sort of indexing to final average pay, whether it be that you completely ignore phased retirement pay and just take your high pay from when you were a full-time employee or you annualized pay while you're a phased retiree or you index your final average pay to whatever increases you gather. There's any number of mechanisms, but just recognize that you don't necessarily want people to lose out because of that final average pay.

I think there was some discussion in one of the sessions yesterday related to the question at the EA meeting having to do with final average pay and how the IRS felt about reducing benefits due to drops in final average pay. The jury is still out with them, but I think in general, the spirit of phased retirement from most employers that I've talked to is not to try to reduce the pension benefits. So they would consider doing something that maintains final average pay.

Two-tier Plans. Considering two-tier plans, I haven't seen a lot of employers go this route. It's sort of a jury-rigging in the existing regulations that just causes a lot of administrative headaches. But it is conceivable that you could have two pension plans or two tiered plans within one plan, one set being the accruals that occur up until phased retirement eligibility and a second set of formulas that apply subsequent to phased retirement until full retirement. So you're separating the two from how benefits accrue, what kind of early retirement subsidies you provide, possibly even payment options that are available. Administratively it's quite cumbersome, so the pressure is really more to lift some of the restrictions that are out there so you don't have to get too creative.

Accruals for part-timers. Accruals for part-time employees is a big deal because most phased retirees obviously would choose to be part time and, depending on their level of part time, may not be eligible for continued benefits within an organization. Particularly on the defined benefits side, you need to identify what you will provide for the phased retirees and what complications that creates for all other part-time employees you have within your organization who may not be phased retirees but simply part-time employees.

Eliminate Early Retirement Subsidies. Another approach could be to eliminate early retirement subsidies. There are some people that believe that the only impediment to having phased retirement is the fact that we have early retirement subsidies in a lot of our traditional pension plans, such that we are encouraging our employees to exit their organization through retirement as early as 50 or 55, depending upon early retirement subsidies.
We really create a cliff of net retirement worth when those subsidies are at their highest value, and it works against wanting to extend the working lifetime of those individuals unless there's a way to allow access to those subsidized early retirement benefits while continuing to work. But an elimination of those early retirement subsidies would eliminate the incentive for folks to retire, and that concept is heavily

embedded in a lot of the hybrid or cash-balance type plans that have gone into play of late.

Deferred Retirement Options Program (DROP) Look-alikes. We also look at exploring DROPs look-alikes. How many in the room are familiar with DROPs as well within the public sector? OK, a few. We're going to spend a few minutes on that, just by way of illustration, to understand how that might be of some benefit to the private sector.

Developing db(k) Plans. Some other ideas that we have toyed around with is creating db(k) plans, as I've called them—basically they are defined benefit plans that are a single trust along with the defined contribution plans, so there's just more flow and ease of how those retirement net assets are considered available for a phased retirement.

Suspend the Rules. In many plans, even after normal retirement age, if you come back to work and are rehired, they can suspend your pension accruals. There is opportunity for some employers to eliminate their suspension-of-benefit rules after normal retirement age, and they may not be doing that today, so it's an easy way to adjust existing programs to be more phased retirement-friendly.

There are public sector tools. I don't know that when they first put them in place, they would have admitted that it was a phased-retirement tool as much as it was an early retirement tool. Watson Wyatt has looked at specific case studies in organizations that say they have a phased-retirement arrangement.

I mentioned that the public sector kind of has a more refined use of phased-retirement programs. But surprisingly, many of those public sector arrangements, whether they be state or local government entities or university entities, many of them were using them as a mechanism to accelerate retirement—to consider tenured professors or people who have gone to a more senior level within the state structure while they preferred to migrate in newer workers. Well, the demographics don't play that well to that; but that was the intent of some of these originally.

How DROPs Work

How DROPs work: Employees agree to retire at a future date on a current level of pension. They're usually made available within public sector plans when someone reaches the maximum accrual within the plan—let's say there's that service cap—or they meet their early retirement or normal retirement-eligible criteria. So the employee says, "OK, I'm not going to retire yet; I'll retire at a future date. But I'll have my pension based on a current level that has been accrued. So I won't get future pay increases recognized or anything.

But as I continue to be employed, my pension benefit is going to start to be paid. I don't get it at my disposal, it's going to go into a DROP account, as it's called. It's like a defined contribution account, in which the pension check is written and goes into that account in your name and continues to earn interest during your DROP period or your phased retirement period. That interest crediting can vary, depending on the program. It can match whatever the trust assets earn with a guaranteed minimum. It can be indexed to treasuries or any other market index.

At actual retirement there's usually a defined DROP period, three to five years long when you fully retire, you get both the lump sum value that's accumulated in the DROP account and the pension check no longer goes into the account, but comes directly to the pensioner.

Within the public sector, where there's not typically lump sum payments available from their programs, it kind of serves two purposes: It allows them to receive their pension along the way during their working lifetime, and then they have a lump sum as part of their pension payment.

Cost Neutrality?

I indicate at the end here that most programs are not cost neutral. They can be quite expensive, so there is a price that goes along with some of these programs, although some of them have definitely been priced to be cost-neutral, either in how long the drop period is or what type of interest gets credited on the account. Many public sector plans also require employee contributions. Some programs require you to continue those employee contributions, even while you're in the DROP period.

Examples

I'll walk through a quick example so you can get a sense for it:

Assume we've got a formula that accrues at 2 percent per year, no service cap on this particular one. When you reach age plus service equal to 80, you're eligible for unreduced retirement, and therefore you're DROP-eligible. I've got someone who is 55 and 25, eligible for a $2,000-per-month benefit, so that requires a $48,000 final average earnings, using the assumption of a single life annuity at age 60 of 10.8.

So if this individual DROPs now and then retires five years later, they would accumulate $150,000 in their DROP account, assuming an 8 percent interest crediting. Then they would receive the $2,000 per month annuity. If you annuitize the DROP account as well, they'd be earning equal to $3,160 per month. If they didn't withdraw and continued to work over that five years without entering the DROP, assuming 3 percent annual pay growth, their annuity would only grow to be $2,780 per month. So in this situation, it is a financial advantage for the employee to take the DROP program, and presumably there's some expectation that the employee might have otherwise elected to retire on an unreduced basis at age 55 and gone to work somewhere else. So you are essentially extending the working lifetime of five years.

They really have been successful programs, whether they've been cost-neutral or otherwise, because it is seen as a real positive that within their existing jobs, they can continue to receive full pay as well as their pension even though they may not have access immediately to their pension. Administratively, though, it is cumbersome for those entities that put it in.

FROM THE FLOOR: Excuse me. During the DROP period, does a person have the option of working part-time? And if so, they still don't have access to that pension. So they would have a lower income base.

MS. PAGANELLI: Just to repeat your question for purposes of the recording, I'm curious as to whether or not part-time employment is available during the DROP period. I am not aware of any DROP programs that have part-time employment during the drop period. In the ones that I have seen, part of the arrangement is that you need full-time employment during the DROP period. Is there anyone in the room who would have a different experience?

FROM THE FLOOR: (inaudible due to not using microphone)

MS. PAGANELLI: No, it's not. The question is, where is the phased retirement in the DROP program? In this situation, the phased retirement doesn't necessarily involve reduced work. Is that what you're pointing out? You're right, it doesn't. What it does is extend the working lifetime of these individuals within that organization that they've devoted their career. The incentives can be large enough for them to stay during the DROP period and be willing to work full time, knowing that at the back end a financial reward is greater than if they had stopped working or started working part-time. So you're right, it's a little bit of a different dynamic.

I've talked through some of these advantages and disadvantages. The one thing I will point out is many public sector plans have cost of living adjustments associated with them, and typically during the DROP period, they may lose out on any cost of living adjustments that occur during that period, in addition to any benefit improvements that might occur and whatnot. We have a question over here.

MS. PAGANELLI: The question is, what happens if the employee were to die during the DROP period?

MS. PAGANELLI: Survivor benefits: Interestingly enough, this may not be an absolute statement, but the DROP payment that's made into the defined contribution-type account is paid in the normal form of pension payment. Typically it would be a single life annuity, but it would be the death benefit available if death occurred during the DROP period, plus the standard pension that has a joint survivor component to it. That's my understanding of how that would work.

MS. PAGANELLI: I think it tends to be a single life annuity-type, normal form of a payment that's going into the DROP account that generates the lump sum that is part of any death benefit during the DROP period.

There is some speculation that DROP look-alikes can be helpful in the private sector, and some say, "Well, there's just really no way that our internal revenue code, Section 411 is going to accommodate it," because it has some back loading associated with it when you get into the actual calculations of it. It really doesn't fit with the accrual rules that the private sector is subject to that the public sector is not.

However, some are looking at ways of getting past that and pushing the envelope with the regulations that suggest removing the barriers between defined benefit and defined contribution to allow for these sorts of arrangements. It would accommodate a situation where you retract early retirement subsidies that are in the current program. And although you may change them prospectively, it doesn't help you on benefits earned to date. So if there's a way to allow employees access to those subsidies, yet continue employment, that would be beneficial in some employment arrangements.

401(k), Etc.

Switching for a minute to 401(k), profit sharing and defined contribution types of arrangements, those plans do allow for in-service distributions after age 59 and a half if the plan document allows for them. It's surprising the number of plan documents that don't allow for in-service distributions after age 59 and a half. It's mostly in organizations where the only retirement program they have is a defined contribution-type of arrangement, so there really is an emphasis on it being a retirement program and not something available while continuing to work, but I think as people see phased retirement being a little bit more of an urgent arrangement in their organization, there will likely be some shift.

There's even some push to have even more parity by allowing in-service distributions after age 59 and a half with defined benefit program, so that DB and DC plans can be on equal footing, but then there's even some that say, "Let's allow for in-service distributions from defined benefit and defined contribution plans at the earliest eligible retirement age," which for some plans can be as early as 50. So the IRS is hearing people asking for in-service distributions as early as age 50.

Many defined contribution plans don't have participant loans available, and loans really can be seen as an economic bridge as someone continues in their employment part-time getting access to their 401(k) savings.
Providing payout options that are something other than lump sums allows participants to regulate the flow of income and they don't necessarily have to make economic decisions about large-scale distributions. Again, in a phased retirement arrangement—this is something that involves all the programs—is the part time status. As a phased retiree, there still very well may be the desire to continue to make pretax deferral decisions to 401(k) plans, but many plans are not open to

part–timers. So it goes both ways—some phased retirees may want access to their money; other phased retirees may want to continue to save on a pretax basis.

Welfare Benefits

Welfare benefits: It gets a little dicey, depending on whether the organization allows for postretirement medical benefits, whether it be subsidized or strictly access. Comparing when someone's considered retired to when they're an active employee and how that affects their coverage and cost sharing within a health program is a huge decision. Many postretirement medical programs have service credits towards eligibility, and considering how those service credits continue to accrue or not accrue while someone's in a phased retirement can really affect the decision of someone going into phased retirement.

Long-term Care Benefits

Long-term care benefits are not hugely popular, but within the age cohort of those who would be considering phased retirement, it can be a very important benefit. So some employers are looking, as they craft their programs to be phased retirement-friendly, using that as the catalyst to include long-term care benefits. Integrating with other long-term disability plans, that's where the standard would apply.

Cash Compensation

Cash compensation has been an interesting one, and I've seen it in a couple of situations. We don't have the same restricted regulations. Although there are rules around fair compensation packages, they don't have the rigorous nondiscrimination rules that are prevalent within qualified pension plans.

So there are some opportunities on how you compensate a phased retiree. If there are things that you can't do otherwise, whether it means provide medical benefits or allow them access to their pension benefits, or allow part-timers in segments of these benefits programs—you can consider compensating them through direct pay by paying them some portion more than what they're working at. We use the example of paying 80 percent for a 60 percent full-time employee, so that 20 percent is an acknowledgement that you want them to continue to work, but they aren't going to have access to benefits, such as they are for full-time active employees.

Some employers view that the savings that they will incur for not having an individual taking subsidized early retirement helps to pay for that compensation beyond their actual working years.
Are there any questions on that section?

MR. KALNBERG: I have a question on DROPs. Have you had any experience with what happens at the end of the five years? Is everybody who's eligible going for them, or are people getting to the end of the five years and they don't want to go and they're looking to get out of it?

MS. PAGANELLI: My experience is that they leave, they fully retire. Now, I don't have any statistics on whether they fully retire from that organization or what they do subsequent to that. I don't know if anyone else has any relevant information on this post-DROP retirees. No? Okay.

FROM THE FLOOR: (inaudible)

MS. PAGANELLI: The question is, are there problems with the integration of health care benefits and Medicare? The answer is yes. If you consider that they have medical programs available to employees post-65, the employer program is primary. Medicare is secondary.

If you are a full-time employee eligible for active medical benefits post-65 from your employer, it means the cost has shifted from Medicare to the employer, so yes, in that regard. Now, if the individual is a part–time, post-65 employee not covered by the employer, then Medicare becomes primary.

Your question triggers another thought that I usually share much earlier than this in presentations. That is what people view phased retirement to be. Phased retirement for many is the concept that I'm going to gradually reduce my commitment to work starting—I don't know—age 55 through to 65. When the reality of the demographics is such that no, phased retirement really has got to go beyond age 65 for us to fill the demographic gaps that we're going to be seeing. So I always encourage the shift to be not just focusing on extending the working lifetime of people who are in their 50s, to get them to stay to 65 instead of 60, but asking and encouraging people through your programs to work to age 70, perhaps. Some of the articles you'll see written really are focusing on pre-65 phased retirement. So questions like Medicare are key, because if I'm phased retiring pre-65, I'm part time. I have no medical benefits from my employer. I'm not yet eligible for Medicare. I'm kind of in this hiatus where medical benefits are the number one thing on my mind. But if we're looking post-65, then the scenario is a little different based on what Medicare looks like today, right?

FROM THE FLOOR: (inaudible)

MR. PAGANELLI: Right, which is what I have. So the question was, if you're part-time and therefore under the threshold for being eligible for employer benefits, you would be able to apply for Medicare benefits post-65?

FROM THE FLOOR: (inaudible)

MS. PAGANELLI: If I continue to be under the active plan that would be primary. They would still be eligible for Medicare benefits, but the employer plan would bear the cost from a plan coverage standpoint.

Changes

I just wanted to share some changes that have occurred in recent years that facilitate phased retirement.

The Social Security earnings tax—where if you earn too much money you have to pay taxes on your social security benefit—they did eliminate that for workers age 65 and older, so that is a positive in that you don't have to pay taxes on Social Security if you're continuing to work post-65 and are over the income thresholds that were previously defined. It's still not in place for the age 62-65 receiving their Social Security benefits early. I've not heard recently—there was some discussion early on that it might be extended to that age bracket, but I've not heard any momentum there.

The minimum distribution rule, so the age 70 and a half rules have been simplified, so that again is something that is on the right side of the page for phased retirement. Same with the combined 415 limits—those are now gone and allow for more flexibility. The simplification of the determination letter process can also facilitate some of this.

It has now been three years—I can't conceive where the time has gone—but there was the Phased Retirement Liberalization Act put forth in July 2000, that allowed in-service pension distributions if you were age 59 and a half or had 30 years of service with your current employer. That was a step in the right direction—maybe not far enough—because there are a lot of employees who, if they didn't have 30 years of employment with their final employer, would be precluded from a phased retirement opportunity at the end of their career under this act. The act has never been reintroduced, but my understanding is that Charles Grassley has the same team working with him as he did back in 2000. It is still on their list—it's just not on the top of their list. Perhaps we will see more from that.

Bringing It Front and Center

I mentioned that we've been a little distracted on phased retirement-type issues because of the economy and corporate integrity and some of the issues that focus elsewhere, so it will be interesting to see when the momentum picks up legislatively. The IRS did, last August, request comments on phased retirement, which was viewed quite positively. They wanted employer and practitioner views on the topic to help guide them in any regulations they might put in place.

Now, it's gotten somewhat backseated by the proposed age discrimination regulations and what not. In fact, I had the opportunity to be in a forum with Paul Schultz from the IRS. He listed all of their in-progress projects, of which phased retirement was one. He indicated to the audience that it was not high on their priority list. So I made a point of talking to Paul at the end of that session to say that it's still on your list, but I wouldn't put it at the bottom. I would recognize it as being something that could be fruitful now as opposed to five years from now, just because there are so many organizations trying to plan and feeling restricted, whereas I think the IRS, just because of the demands on it, is dealing with the things that are applying the most pressure right now.

So to the degree you have clients who are really wanting to apply pressure, send Paul Schultz or someone at the IRS an e-mail letting them know you'd like to see them move forward more quickly.

IRS Request for Comments

Basically in the request for comments, the IRS framed some questions that they wanted some clarification on related to existing regulations.

They view defined benefit plans as being maintained primarily for providing benefits after retirement. That's the way the statutes and regulations are written, so how would this in-service distribution of pensions support that, and how do we recreate what it means to fit within that framework? Or do we request of the IRS that they throw that view out—retirement benefits don't mean that any more because of how people are going to migrate from active employment to retirement.

They wanted input as to whether in-service distributions, if allowed, were only available at a certain age threshold or if you reduced your workload by a certain level. They wanted some indication of how many bright line rules we have to see around phased retirement from the IRS.

They inquired about how additional benefits would be calculated during the phased retirement period, getting a final average pay that we talked about for traditional plans, as well as how early retirement subsidies would be accommodated. And then they explored looking for additional guidance that might be needed in the areas of nondiscrimination testing, benefit accrual rules and benefit payment regulations.

I think the final question they had was, "How important is it to be able to distinguish between an independent contractor who retires from his or her previous organization and someone who is a phased retiree with their former organization?" I think where they were headed to get the answer that they did get, and that is, there shouldn't be a difference. An employer should be able to create the same opportunity for someone who spent their career in an organization as they're able to create by hiring a retiree from another organization.

I had the opportunity to get all of the submitted comments that went to the IRS, and these are the organizations who did submit comments. Of the four personal comments, two were e-mails from individual retirees. Of the other two, one was a representative from Ernst & Young who wasn't speaking on behalf of Ernst and Young, and there was an individual from the Urban Institute, again speaking on behalf of his personal comments, not the actual Urban Institute.

The submission themes, if you were to go through the pain of reading through them like I did, were first and foremost, everyone pretty much seems to be in the camp of encouraging flexibility and balance without mandates. We really want to encourage phased retirement, but we don't want it to be something that everybody has to put in their programs—that it be something flexible depending on the organization and its industries and its demographics and all the things that drive their workforce management and the kinds of structure that they need.

Most of the submissions were also requesting that retirees who were actually retired and eligible employees, continue to have access to or gain access to their retirement net worth—essentially letting them have access to in-service distributions, to pension benefits that have already accrued. They were looking for some stronger definition on bona fide retirement so that we aren't guessing what an appropriate waiting period might be to create a bona fide retirement if, in fact, a bona fide retirement continues to be a trigger for how we structure phased retirement programs.

Nondiscrimination Testing

When it comes to nondiscrimination testing, I really didn't get into that in the meat of the presentation. But phased retirement opens up an arena where heavy abuse could occur if not appropriately managed when it comes to nondiscrimination. Yet all of the responses acknowledge that this is such a fluid area of change that we don't really know what nondiscrimination rules ought to look like and how they ought to be structured. So everyone was pretty heavy on the idea of having it be facts- and circumstance-based until we have more of a sense for how it evolves.

There was discussion about creating the opportunity for DROPs in the private sector and thus creating more parity between defined-benefit and defined-contribution values, and also then getting at the age 59 and a half availability for defined contribution when it's not available for defined benefits.

Then, finally reconciling with other government agencies, one thing that the IRS doesn't have purview over is the Age Discrimination Act. Anytime we're talking about benefits to older workers, it brings into play the age discrimination rules. There's a lot of discussion about phased retirement design being likened to the wave we all went through with early retirement programs, where there were no rules set for that, they crafted some special nondiscrimination rules or other special rules to accommodate those kinds of programs. So we need to be thinking along those same lines for phased retirement and reconciling it like the early retirement programs did with the Age Discrimination in Employment Act (ADEA) for waivers and communication standards.

FROM THE FLOOR: (inaudible)

MS. PAGANELLI: The question is, "Who's going to change the definition of bona fide retirement?" I don't think it rests primarily and solely with the IRS. There are exceptions in ERISA that also reference that same terminology, so there are some legislative requirements to pull that together.

FROM THE FLOOR: Have DROPs been successful in the public sector?

MS. PAGANELLI: In the concept of extending the working lifetime, the answer has been yes, and also just noticing the prevalence of the program would be another signal that they're working.

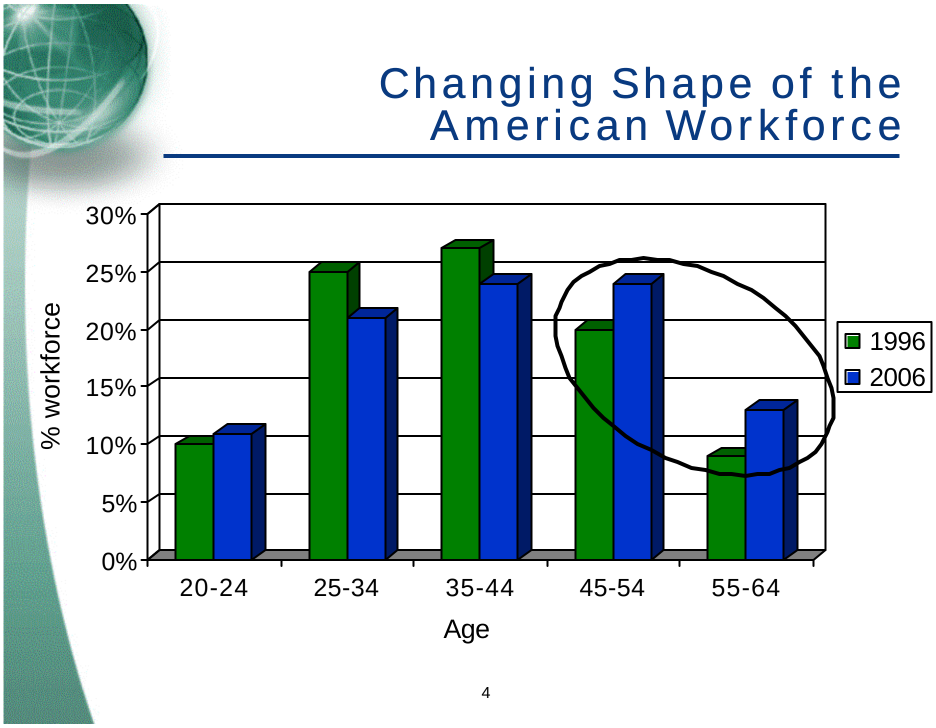
I think there have been some situations where cost may have been more and the administrative burden been more than what they anticipated going in; so from that measure success may have been a little bit dampened.

MR. KALNBERG: I just wondered if we've seen any attempts to use phased retirement in conjunction with early retirement windows as an incentive and just available for a short period of time.

MS. PAGANELLI: For a window. I have been involved in conversations along those lines, as far as how to blend the two and have it be a window of opportunity. That's one area I didn't summarize as in the responses, but what was seen was sent to the IRS. That is whether or not phased retirement benefits fall under the anti cutback rule where there is Section 411(d)(6).

The theme being, "No, give a waiver on these benefits, because they may only be required or necessitated for a window of time, and we may not get it right the first time as we're working through the demographics and what works and what doesn't. So we really don't want to be bound by 411(d)(6) on how these programs flow through." So in that regard I think the answer is yes. Anything else? Well, thank you. Go forth and phase retire.

Chart 1


Changing Shape of the American Workforce
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45-54
55-64
Age
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2006
4