North Carolina Department of State Treasurer

Retirement Systems Division

February 2005

Report to the General Assembly:

Evaluation of North Carolina's Policy Governing State Retirees Returning to Service

Table of Contents

Acknowledgments

The North Carolina Department of State Treasurer Retirement Systems Division gratefully acknowledges the following organizations for their invaluable contributions to this report:

NC ASSOCIATION OF COUNTY COMMISSIONERS
NC ASSOCIATION OF EDUCATORS
NC ASSOCIATION OF SCHOOL ADMINISTRATORS
NC DEPARTMENT OF PUBLIC INSTRUCTION
NC DEPARTMENT OF TRANSPORTATION, STATE HIGHWAY ADMINISTRATION
NC LEAGUE OF MUNICIPALITIES
NC OFFICE OF STATE PERSONNEL
NC RETIRED GOVERNMENTAL EMPLOYEES ASSOCIATION
NC RETIRED SCHOOL PERSONNEL
NC SCHOOL BOARDS ASSOCIATION
NC SCHOOL COUNSELORS ASSOCIATION
PROFESSIONAL EDUCATORS OF NC
STATE EMPLOYEES ASSOCIATION OF NC

Executive Summary

The North Carolina General Assembly, in the 2004-05 Appropriations Bill directed the Retirement Systems Division to "conduct an analysis of the postretirement reemployment issue, including a survey of peer State systems, cost analyses, review of relevant impacting federal regulations, and the administrative impact of various postretirement reemployment policies."[1] This report fulfills the legislature's directive with an in-depth examination of and recommended adjustments to the State's current return-to-work regulations. This report also provides recommendations for future work force retention policy in North Carolina's public sector.

The Department of State Treasurer and the Retirement Systems Division have a constitutional mandate to protect the financial integrity of the State's retirement systems. Additionally, the systems serve as a powerful recruitment and retention tool for public schools, hospitals, counties, municipalities, and other government entities that generally cannot offer compensation levels on par with other sectors.

To those who commit their careers to public service, the promise of a dependable and sustaining post-employment benefit must be kept. For retirees in the systems, funds for continued cost-of-living adjustments are imperative if their benefits are to remain a viable source of income. Recruitment and retention of a quality government work force now and in the future rests largely on a strong, fiscally sound public pension plan. The systems' financial integrity and its federal tax-exempt status must be preserved if these responsibilities are to be met.

Background

North Carolina's public employee retirement systems have long recognized the right of a public servant to return to work after retirement. Many government workers retire from state government and return to work full-time with local government or with a private sector organization while continuing to receive a full pension benefit. Neither of these arrangements presents a regulatory or financial challenge to the Teachers' and State Employees' Retirement System.

Restrictions, however, are in place for retirees who return to work in the same system from which they retired. With the exception of those who return to teach, state retirees who return to work for a state entity in a non-covered position[2] after retiring have a salary cap enabling them to earn up to $25,420, or 50 percent of their pre-retirement salary, whichever is greater[3]. (Note: State retirees who return to work for a state entity in a covered position[4] will once again become contributing members of the Retirement System and pension payments will cease until the employee retires.)

[1] House Bill 1414, Section 31.18A.(e), 2003
[2] Non-covered positions are those that do not qualify for membership in the Retirement System. This includes positions that are part-time, temporary, interim or on a fee-for-service basis.
[3] GS 135, Article 1, Section 3, Subsection C
[4] Covered positions are those that meet the statutory requirements for membership in the Retirement System.

The salary cap serves a critical purpose. Earnings restrictions create a disincentive to retire as soon as possible for state workers who want to continue in their current job. Without restrictions in place and depending on the level of compensation upon returning to work, a state worker could earn as much as 150 percent of his pre-retirement salary by retiring as soon as eligible and collecting a pension benefit plus full pay.[5]

Lifting the cap potentially encourages workers to retire earlier than they would otherwise. This poses a financial threat to the state retirement system's pension funds. Any policy that changes retirement behavior ultimately impacts the retirement systems. Policies that include incentives that compel personnel to retire earlier than historically observed, planned for and funded, could cause long-term damage to the pension system because the actuarially projected funding levels will have changed.

The system's actuarial projections are based on contemporary behavioral trends in North Carolina's public work force. The projections assume that public sector employees do not all retire at the same time. Some retire as soon as they are eligible. Others work as many as 20 years beyond the time when first eligible for retirement. Based on historical experiences and periodic reevaluation, the actuary projects probabilities for when an employee is likely to retire. These projections are pivotal because the State funds pensions on the basis of when each employee is projected to retire. Introducing an incentive that alters employee behavior by encouraging earlier retirements invalidates these assumptions and substantially increases the funds needed to pay for the system.

As mentioned above, an exception to the earnings restrictions for state workers who return to teach was established by legislation enacted in 1999. This exception, scheduled to sunset in July 2005, was allowed in response to a shortage of teachers in North Carolina's public schools. The legislation was intended to provide an incentive for retired teachers to return to the classroom. To comply with IRS regulations and protect the State's tax-exempt status, the exemption requires teachers to take a six-month break from service before returning to work full-time.

There is evidence to suggest that lifting the salary cap does in fact alter retirement behavior. The Retirement Systems' analyses of the salary cap exemption for teaching indicated that lifting the cap and allowing retirees to return to work and earn both a pension and a full salary led to accelerated retirement rates among active teachers.

Since the teaching exception was enacted, policy makers have considered enacting exemptions for other occupational groups. For example, school administrators and support staff, Department of Transportation engineers, corrections officers and nurses in state facilities all report having personnel shortages. To date, no further exemptions have been granted by the General Assembly, pending further debate and study.

Recommendations

The six recommendations offered in this report are intended to:

[5] Pre-tax earnings

- Recognize and reimburse the pension funds for the actual cost of any exemptions to return-to-work policy;
- Bring all return-to-work policies into compliance with IRS regulations so as not to jeopardize the system's tax-exempt status; and
- Encourage lawmakers to explore work force retention policies beyond return to work.

Recommendation 1: The Retirement System recommends that if the existing return-to-work exemption for those who return to teach is to be retained temporarily, or made permanent, that the costs must be recognized and appropriately funded.

As shown in the table below that was prepared by the Retirement Systems' actuary, any extension or addition of exceptions to earnings limitations will require additional appropriations amounting to millions each year.

Exemption Period 1: Six Months (current law)*				
		Extend Sunset to:		
Group	**Permanent Exemption**	**6/30/2006**	**6/30/2007**	**6/30/2008**
Teachers	$28 Million (0.28%)	$4 Million (0.04%)	$7 Million (0.07%)	$10 Million (0.10%)
Assistant Principals	$2 Million (0.02%)	0	0	$1 Million (0.01%)
Central Office	$1 Million (0.01%)	0	0	0
Principals	$2 Million (0.02%)	0	0	$1 Million (0.01%)
Support Staff	$2 Million (0.02%)	0	0	$1 Million (0.01%)
All other State personnel	$39 Million (0.39%)	$6 Million (0.06%)	$11 Million (0.11%)	$15 Million (0.15%)
Total	**$83 Million (0.75%)**	**$12 Million (0.11%)**	**$21 Million (0.19%)**	**$31 Million (0.28%)**

*Based on $11.1 Billion payroll

The following steps should be taken to effectively implement **Recommendation 1**.

A. Consult with the Retirement System's actuary to accurately establish the total cost of the exemption and align funding provisions to these projections.

B. Determine the appropriate funding source, whether from individual employees or a general fund appropriation, to cover the costs of current exemption.

Recommendation 2: Any new salary cap exemptions adopted by the General Assembly should include cost evaluations and appropriate funding measures.

Recommendation 3: Conduct a study to determine if salary cap exemptions are an effective personnel strategy for enhancing retention.

Ensuring that North Carolina's return-to-work policies comply with IRS regulations will require two adjustments to state law, which are embodied in recommendations 5 and 6. Detailed explanation for these changes is provided in section V of this report.

Recommendation 4: Establish in statute a required separation from service between the times of retirement and returning to work for all retirees that resume work within the same retirement system, even those subject to earnings limitations.

Written direction from IRS regulators indicates that the current policy allowing retirees to return to work immediately, **including those subject to earnings restrictions** (emphasis added), places the Retirement System's tax-exempt status in jeopardy. Loss of its tax-exempt status would be an enormous cost to the State. This would mean that employee and employer contributions, as well as investment earnings, could not grow in the pension system tax deferred. Establishing a mandatory separation of service for all retirees who return to work is required and will ensure compliance.

Recommendation 5: Specify in statute that pre-existing employment agreements between employers and employees prior to retirement are prohibited.

A common practice for employees who return to work in the same system from which they retired is to establish a post-retirement employment agreement to be fulfilled when they return after the required break in service. This practice is explicitly prohibited by the IRS and threatens the Retirement System's tax-exempt status.

The various work-life issues driving the need for changes to North Carolina's return-to-work policy, including labor shortages and impacting demographic shifts, are prevalent in government entities across the United States. Various methods for retaining quality employees, other than return-to-work exemptions, have been implemented or proposed in other states and at the federal level. Such practices have had varying degrees of success in terms of both quality and quantity of employees retained. One of the criteria North Carolina should consider when assessing retention programs is the degree of empowerment the State will have with regards to not just retaining personnel, but also the extent to which a particular program impacts the State's overall productivity.

The purpose of recommendations 8 – 8C is to encourage lawmakers to consider alternative approaches in remedying worker shortages.

Recommendation 6: Implement Retention Programs that will encourage valuable employees to postpone retirement and help the State meet its personnel objectives.

Recommendation 6A: Conduct a comprehensive analysis of the State's total employee turnover. Derive the associated turnover costs. Begin to recognize these costs as operating expenses funded from departmental budgets. Develop a new retention program that gives department and agency management the ability to offer valuable veteran employees a bonus incentive to postpone retirement.
*****The North Carolina Office of State Personnel is currently in the process of completing a report for imminent release that addresses this very issue.

Recommendation 6B: Evaluate and prepare for implementation of a State phased retirement program.

Recommendation 6C: Increase the retirement accrual rate for employees who have reached retirement eligibility to encourage continued service.

These options are presented in greater detail in section VI of this report. Any costs to the retirement system generated by these approaches must be evaluated and funded appropriately.

The North Carolina public sector may experience labor shortages as the Baby Boomer generation reaches retirement age and begins its exodus from the work force. However, the extent of potential future labor shortages, and how to best address them, remains an unresolved issue. Thorough evaluation of the State's current and future labor needs is an essential first step toward developing appropriate personnel policies, including retention and return to work programs. Thoughtful discussion and debate of work force policy, including the many issues presented here, are necessary if North Carolina's government is to continue to maintain a qualified workforce that will meet the needs of its citizens.

The State's strong public-pension plans are now and will remain the public sector's primary recruitment and long-term retention tool for quality workers with many employment choices. North Carolina should prepare for the future by establishing policies that retain quality workers without compromising its public-pension plans.

I. Introduction

This report attempts to provide policy makers with guidance and insight into North Carolina's Return to Work policy. The General Assembly instructed the Retirement System to ""conduct an analysis of the postretirement reemployment issue, including a survey of peer State systems, cost analyses, review of relevant impacting federal regulations, and the administrative impact of various postretirement reemployment policies."[6]

The primary questions that this report seeks to answer are: Should policy makers change the State's longstanding Return to Work policy? What are the regulatory restrictions? What are the potential consequences policy makers should consider before implementing further changes? What are the costs? For each question, there are multiple associated issues and subsequent questions that must be addressed. This report synthesizes these components into recommendations for protecting the Retirement Systems and maintaining a quality workforce.

North Carolina's policy governing members of the Teachers and State Employees Retirement System who return to work with an employer in the same system is coming under increasing pressure for modification. Proposals for amendment or exception to the current ***Return to Work*** (RTW) policy are principally motivated by demographic and/or economic factors. The reported list of occupation groups with shortages appears to be growing. The aging of the Baby Boomer cohort and shifting opportunities in the labor market are leading an expanding group of Department and Agency heads to declare the existence of shortages in certain occupational classes. Lifting the **salary cap**, which has been in place since 1951 and is the central feature of the State's Return to Work policy, is suggested as a means to encourage retirees with needed experience to return to the public sector workforce. The primary question confronting policy makers is whether or not the current RTW policy should be changed?

Lifting the salary cap substantially increases the net income of a retiree because he or she can then earn both full compensation and a pension. For retirees who return to the same position occupied prior to retirement, their income can approach 150% of what they earned prior to retirement. This explains the proposal's popularity. Another reason for the momentum behind lifting the cap is that by hiring a retiree, employers no longer have to make the retirement or health care contributions necessary for an active employee. Despite its apparent appeal, there are major obstacles to this strategy.

While removing the cap could serve as an incentive for retirees to return to active service, and though the proposal does have enthusiastic support among many employers, retirees and soon-to-be retired employees, there are serious consequences that must be accounted for before such a policy change is implemented. For example, allowing retirees to earn both a pension and a salary from the same system, referred to as an **in-service distribution**, puts the State at odds with federal regulations and potentially jeopardizes North Carolina's tax-exempt status. The United States Internal Revenue Service explicitly prohibits in-service distributions, or double dipping, as it is commonly known, under most circumstances. Further, the funding status of the State's Pension Funds could be dramatically affected if lifting the cap caused retirement rates

[6] House Bill 1414, Section 31.18A.(e), 2003

among active personnel to increase. Administration of the Retirement Systems would also be negatively impacted if retirement rates increased beyond the already astronomical levels projected for the next twenty years (see **Appendix 1**).

The mounting pressure to alter the RTW policy highlights a need for new policies that address and resolve major personnel issues confronting the State. Verifying the current and projected extent and duration of personnel shortages is a necessary first step toward developing comprehensive strategies that will help the State meet its future workforce needs. Although not a perfectly correlated measure of future workforce needs, the actuary for the Retirement Systems Division has projected that the number of retirees in the system will increase from the current level of 180,000, to 383,000 by the year 2022 (see **Appendix 1**). Presumably most, if not all, of these retirees will have to be replaced in the State's workforce. The question is with whom?

Some studies suggest that the future labor market may be sizably smaller than it is today. If this is true, replacement cohorts will be in greater demand and thus more costly. Perhaps the best way to mitigate short and long-term shortages is through retention programs that serve as incentives for veteran employees to postpone retirement and work longer. Such programs could be coupled with intensified recruiting campaigns to compel new generations of workers to enter North Carolina's public sector.

The core of the RTW, and the determining factor in whether or not it needs to be modified, is the cost effectiveness and permissibility of in-service distributions. Are salary cap exemptions that allow in-service distributions a cost neutral and effective strategy for achieving personnel objectives? Do in-service distributions violate federal, perhaps even State, law? The answer to the cost neutral question is to be determined through analysis. The permissibility question is a debatable one that hinges on the definition of retirement and Internal Revenue Service regulations. As the State's workforce enters an era increasingly characterized by the transition of the Baby Boomers from active employees to pensioner, the intended meaning of *retirement* will become increasingly important.

This report seeks to clarify these issues through an evaluation of the following areas. North Carolina's current Return to Work policy will be defined and evaluated. The sole exception in the State's history to the Return to Work policy, the Salary Cap Exemption for Teaching, will be evaluated in terms of impact and costs. Finally, recommendations to help policy makers strengthen and enhance the State's Return to Work policy will be provided.

The findings in this report were generated by conducting primary and secondary research; surveys with other State Retirement Systems; interviews with key stakeholders and administrators; consultations with the Internal Revenue Service; and analysis of various data. The report contains multiple appendices and an attachment.

II. North Carolina's Return to Work Policy

North Carolina's Return to Work policy was established in 1951. The central feature of the policy is an earnings restriction – a limitation on the amount of salary that can be earned by a State retiree who returns to service with an employer that participates in the Teacher's and State Employee's Retirement System. This section provides the legislative history of the policy, discusses the purpose of the restrictions, and explains how lifting them creates significant costs that must be addressed in order to protect the financial health of the Retirement System.

Legislative History

- House Bill 273, passed on April 5th, 1951, began the legislative history of the Return to Work policy. The bill established restrictions for employees who retired on a reduced benefit (early retirement). It included the following language:

"*Should a teacher or employee who retired on an early retirement allowance be restored to service prior to the attainment of the age of 60 years, his allowance shall cease, he shall again become a member of the retirement system, and he shall contribute thereafter at the uniform contribution rate payable by all members*."

Since April of 1951 the restrictions on returning to work have evolved to include retirees that retire with an unreduced benefit, and have increased the applicable age of the retiree.

- House Bill 409, enacted in 1969, amended the restrictions significantly, extending the policy to include those employees that retired with an unreduced benefit (service retirement) under the same return to work restrictions as early retirees:

- Specific monetary salary restrictions appeared in 1983. Salary restrictions were set as a percent of an employee's final salary. The salary cap is adjusted each year for inflation.

- The most recent major change to the Return to Work policy took effect on January 1, 1999. It is the sole exception to the Return to Work policy for State employees who return to work after retirement as qualified teachers in the public school system. Under these provisions, teachers are not subject to the return to work salary cap and are thus able to earn a full salary in addition to his or her full pension. The exception, referred to as the Salary Cap Exemption for Teaching, will be covered in another section.

Purpose of Salary Restrictions

The purpose of salary restrictions placed on retirees who return to the same system they retire from is not explicitly stated in statute. Further, neither the General Assembly Library nor the North Carolina Department of Justice archives possess the committee notes that would have possibly accompanied the legislation that established the restrictions in 1951, or the modifications in 1969. Without this information, policy makers must rely to some degree on educated speculation as to the purpose, and the value, of the earnings limitations; as well as whether retaining, modifying or removing them is the most expedient and efficient solution for achieving the State's personnel objectives.

In the 1941 session of the General Assembly, the legislature created the North Carolina Retirement System with House Bill 52. The bill read in part, "AN ACT TO PROVIDE OLD AGE SECURITY FOR OLD AND INCAPACITATED TEACHERS, AND STATE EMPLOYEES…".[7] Though the language is not politically correct by modern standards, it is the first and only expression of the purpose of the State's Retirement System. It was not long after that the General Assembly established the State's policy governing the return to work of retired public employees.

This report presents two overlapping theories for why the restrictions were implemented, and perhaps why policy makers should give thoughtful consideration to their retention: 1) Pensions are for Retirement, and 2) Lifting the Salary Cap is an Incentive to Retire

Pensions Are For Retirement

The most compelling public policy reason for enacting, and for retaining, the salary cap is that it facilitates the stated purpose of the Retirement System, the State's definition of retirement, and with federal regulations governing public pension systems. The state and federal positions are that a pension is a post-employment benefit, an income replacement, to be drawn when an employee stops working for an employer.

As stated in the act that created it, the North Carolina Retirement System exists to provide income security for old and incapacitated State employees. Further, this act defined retirement as "the withdrawal from active service …".[8] It would thus appear that retirees' 'returning to work' is in conflict with the State's definition of retirement, and the purpose of a defined benefit pension. It is also potentially in conflict with the federal government's position on the purpose of a public pension system.

The U.S. Internal Revenue Service stipulates that pension systems exist to "provide for the livelihood of the employees and their benefactors after the retirement of such employees…".[9] The pivotal phrase in the federal regulation is 'after retirement'. There are at least two possible interpretations of the expression 'after retirement'.

One interpretation is that 'after retirement' refers to any period of time following the moment from which an employee qualifies for retirement under a pension plan, files the necessary documents, is approved for said retirement, and begins to draw a pension. This could be considered the *technical* definition of retirement.

---

[7] House Bill 52, Chapter 25, Public Laws of North Carolina, 1941, p.20
[8] House Bill 52, Chapter 25, Public Laws of North Carolina, 1941, p.22
[9] Federal Code, 26 CFR Ch.1.401-1(a)(2)(i))

The historical interpretation, which the IRS appears to have intended given current policies and historic rulings, is that retirement, while commencing at the technical moment described above, is a *segment* of life that begins when an individual no longer works for income and draws a pension as a income replacement. This notion is strengthened by the IRS's prohibition of in-service distributions (earning both a salary and a pension from the same employer) and the penalties imposed on individuals who receive them (see **Appendix 4**) and systems that permit them (see **Section V**).

State and federal definitions of retirement and the purpose of a pension provide that pensions are income replacement, not income supplements. The salary cap reflects this perspective because it renders the total amount of income earned as salary prior to retirement roughly equivalent to total income (pension plus capped salary) after retirement if a retiree returns to work. In fact, if an employee does not retire and continues working, then he or she continues to accrue service credit and potential salary increases; both of which will increase the eventual pension amount.

Economic Incentive of Post-Retirement Employment

An overlapping hypothesis recognizes that a policy enabling employees to earn both a full salary and a pension ("double dipping") is potentially a strong economic incentive to retire as soon as eligible, and that the State cannot afford such a policy long-term. It is possible that State legislators implemented earnings restrictions in 1951, just ten years after the system was established, because they recognized the impact double dipping would have on retirement rates, and thus the system's financial status.

To fully understand the potential impact to the Retirement System's funding status from permitting in-service distributions, it must first be understood how double dipping acts as an economic incentive to retire as soon as eligible.

<u>Benefits of Earning a Pension and Full Salary</u>

Service retirement pensions (unreduced pensions) are calculated according to a formula: *total years of creditable service*, *final average salary*, and an *accrual factor* (currently 1.82).

> For example, a State employee of thirty-years (30) with a $50,000 final average salary would receive a pension of approximately $27,300. This employee's pension would therefore be fifty-five (55%) percent of *final average salary*.

If in-service distributions were permissible for this employee, he could retire and then return to work drawing a $27,000 pension and earning the same $50,000 salary, receiving total compensation of $77,300. By retiring and returning to work, the returned employee is now earning one hundred fifty-five percent (155%) of pre-retirement income.[10]

It is reasonable to expect that the average employee offered an opportunity to increase his or her income by fifty percent (50%) would probably do so. The salary cap was likely implemented in

[10] Post-Retirement Salary Plus Pension Benefit divided by Pre-Retirement Salary: $77,300/$50,000 = 155%

part to eliminate the economic incentive to retire as soon as possible and take an in-service distribution. For state workers who would like to continue in their current job, the earnings restrictions serve as a disincentive to retire as soon as eligible.

<u>Costs to the Retirement Systems of Retirees Drawing Pension and Full Salary</u>

Individual pensions are generated by contributions to the State's Pension funds from employees, employers, and investment income throughout each worker's career.

Employee contributions to the pension fund are statutorily set as a percentage of salary. Investment earnings vary according to market performance.

The State's contribution to the Pension Fund on behalf of its employees is determined by the Retirement System's actuary using standard actuarial methods; it is the amount needed, in addition to member contributions and investment earnings, to fund the promised benefits of the System.

To calculate the State's contribution, the actuary uses a recognized matrix of probabilities that includes if and when an employee will retire from the system, what his or her final average salary will be, and how long he or she will draw a pension. **Lifting the salary cap impacts the probabilities that have been used to determine the contribution amounts for each employee's pension.**

- For example, thirty percent (30%) of male State Employees between the ages of 50 and 59, who are eligible to retire with a Service Retirement (unreduced pension), are projected to retire each year.
- That projection jumps to fifty percent (50%) in the first year that a male State Employee aged 50 to 59 becomes eligible for a Service Retirement.
- Lifting the salary cap increases the percent of males in this age bracket who will retire in the first year eligible for a service retirement from fifty percent (50%) to seventy percent (70%).

If removing the salary cap and permitting in-service distributions creates an incentive to retire as soon as possible, then lifting the salary cap will accelerate the retirement rate of eligible employees. This will negatively impact the Pension Funds because many employees will retire earlier than projected and thus withdraw a pension that is insufficiently funded.

The cost of changing the State's Return to Work policy by lifting the salary cap is the difference between the funded portion and the non-funded portion of those employees' pensions who retire significantly earlier than projected due to removing the salary cap.

III. Salary Cap Exemption for Teaching

There has been one instance of the State changing the Return to Work policy. The North Carolina General Assembly enacted temporary legislation in January 1, 1999, permitting in-service distributions for retired state employees who returned to work in the public school system as teachers. Known as the Salary Exemption for Teaching, the Return to Work amendment lifted the salary cap and allowed returned retirees to earn both a pension and full compensation.

The Exception for Teaching has generated a great deal of debate since inception, as policy makers continue to seek the best way to address a personnel shortage. Some groups contend it is inequitable to enact such a policy change for only one group. Others maintain the policy shift is costly and ineffective. Supporters of the policy say that the exception reduces a teacher shortage by drawing retired teachers back to the classroom.

Legislative History

The legislation allowing retired teachers to receive in-service distributions became effective January 1, 1999. It was enacted as a temporary policy, with a June 30, 2003 sunset date. The central features and conditions of the legislation included:

- A retiree must not be employed by the State for twelve (12) months following the retirement date (except as a substitute teacher)
- The exemption was only available to retirees who returned to service to teach in the following capacities:
  - Employed as a substitute teacher or on an interim basis
  - Employed in the teacher's area of certification in a low performing school
  - Employed in the teacher's area of certification in a geographical area determined to have a teacher shortage

- The Exemption for Teaching was amended in 2000. The new legislation dropped the requirement that the retired teacher return to work in either a low performing school, a geographical area with a documented shortage, and the prohibition against permanent employment. The new legislation retained the twelve (12) months period of separation between retirement date and date of return to work.

- In 2001, the legislation was amended again. The amendment reduced the required period of separation between retirement date and return to work date from twelve (12) months to six (6) months.

- In 2003, the legislation's sunset date, the exemption was extended an additional year. The new sunset date was June 30, 2004.

- In 2004, the legislation was again amended and the sunset was once more extended to June 30, 2005. The 2004 amendment attached a funding component to the policy for the first time The new provisions stipulated that Local Education Administrators (LEA) had to pay 11.7% of the salary of all retired teachers the LEA hired.

Purpose of the Exemption for Teaching

The widely recognized motivation for enacting the salary cap exemption was a cited shortage of qualified teachers in the North Carolina public school system. Lifting the cap was viewed as a means to encourage retired teachers back into the classroom.

While the existence and the extent of North Carolina's teacher shortage are enthusiastically debated, it is clear that the annual teacher turnover rate exceeds the State's average turnover rate. It is also evident that there is an imbalance between the supply and demand of teachers. Baby Boomers aging out of the active teacher population, dissatisfaction with teaching[11], and an expanded horizon of professional opportunities for many would-be teachers, are likely the primary causes for not having enough qualified teachers to meet educational objectives. Several major policies, including the federal Leave No Child Behind (LNCB) program and North Carolina Governor Mike Easley's class size reduction initiative, compound whatever teacher supply and demand problem already exists.

One of the education sector's main personnel challenges is retention of new teachers. Department of Public Instruction data reveal that nearly 40% of all new teachers leave within the first three years of entering the profession. After five years, nearly 50% of all new North Carolina teachers will have quit the profession.[12] Evaluating the reasons such a substantial number of new teachers leave the profession and implementing strategies to reduce the turnover may be the most impacting strategy for increasing the supply of qualified teachers.

The retention of senior teachers is another component of the issue that should be addressed. Presently, North Carolina pays teachers on a thirty-year salary step – teacher salaries increase each year for thirty years. After thirty years, however, there are no additional scheduled salary increases. In effect, after an educator has served thirty years in the classroom and reached the height of the salary step, **there is no salary incentive to remain in the classroom**. Veteran teachers are an immensely valuable resource in the State public education system. They are the most effective educators, are reliable personnel (especially in rural areas that have recruiting difficulties), and they serve as excellent mentors to new teachers. Another impacting policy initiative for the State to adopt in order to increase its supply of qualified teachers is to expand the salary schedule; providing teachers with thirty plus years of experience with a salary incentive to remain in the classroom.

The salary cap exemption for teaching put in place in 1999 was established to mitigate a reported shortage of qualified teachers. To date, there has not been a comprehensive review to determine if this has been an effective strategy for reducing teacher shortages. As suggested in the previous two paragraphs, there may be other more effective strategies. At a minimum, the salary cap exemption alone is not likely to sufficiently reduce any existing teacher shortages, and it entails costs.

[11] "System Level Teacher Turnover Report", North Carolina Department of Public Instruction, 2004
[12] "Report on Review of the Certification Process", North Carolina Department of Public Instruction, 2004

IV. Impact Analysis of Salary Cap Exemptions & Implications for Further Amendments

Permanently adopting and expanding a personnel strategy that lifts the salary cap for retirees must be weighed against the costs it generates. In addition to making the Teacher Exemption permanent, proposals have been presented to the General Assembly that will extend the salary cap exemption to other occupation groups. North Carolina must meet its personnel needs. Yet it is in the State's best interest that policies impacting the solvency of the Retirement System are thoroughly evaluated prior to implementation. Damage to the Retirement System's fiscal integrity will undermine the State's ability to deliver the benefits promised to public sector employees. This would seriously weaken North Carolina's attractiveness as an employer, and possibly impact the State's overall fiscal health.

<u>Cost Estimates of the Salary Cap Exemption</u>

The Retirement System's actuary was asked to provide an estimate of the costs to the State's pension funds of lifting the salary cap for teachers, and extending it to other occupation groups. Please see **Table 1** for the actuary's projections. These figures are the estimated **annual** cost of exempting retirees from the salary cap.

The actuary determined that there is a significant cost generated by lifting the salary cap. Extending the Exemption for Teaching to June 30, 2005 generates unfunded costs to the State's pension system equivalent to .04% of payroll, or approximately $4 million in the first year. The cost of the exemption increases the longer it remains in effect. Keeping the policy in place through 2006 and 2007 generates annual costs of $7 million and $10 million respectively. Making the exemption permanent creates an annual cost to the pension fund of $28 million **Table 1** also provides projections for extending the policy to various other groups in the education sector (All Others), as well as all members of the System (Total). The cost of permanently lifting the salary cap for all State government retirees will generate an estimated annual cost to the pension fund of $75 million.

Table 1: Actuarial Cost Projections for Various Salary Cap Exemption Proposals (Annual Cost Based on $11.1 Billion Payroll); Projections calculated in April 2004

Exemption Period 1: Six Months (current law)				
		Extend Sunset to:		
Group	**Permanent Exemption**	**6/30/2006**	**6/30/2007**	**6/30/2008**
Teachers	$28 Million (0.28%)	$4 Million (0.04%)	$7 Million (0.07%)	$10 Million (0.10%)
Assistant Principals	$2 Million (0.02%)	0	0	$1 Million (0.01%)
Central Office	$1 Million (0.01%)	0	0	0
Principals	$2 Million (0.02%)	0	0	$1 Million (0.01%)
Support Staff	$2 Million (0.02%)	0	0	$1 Million (0.01%)
All Others	$39 Million (0.39%)	$6 Million (0.06%)	$11 Million (0.11%)	$15 Million (0.15%)
Total	**$83 Million (0.75%)**	**$12 Million (0.11%)**	**$21 Million (0.19%)**	**$31 Million (0.28%)**

Key Actuary Assumption for Cost Estimates

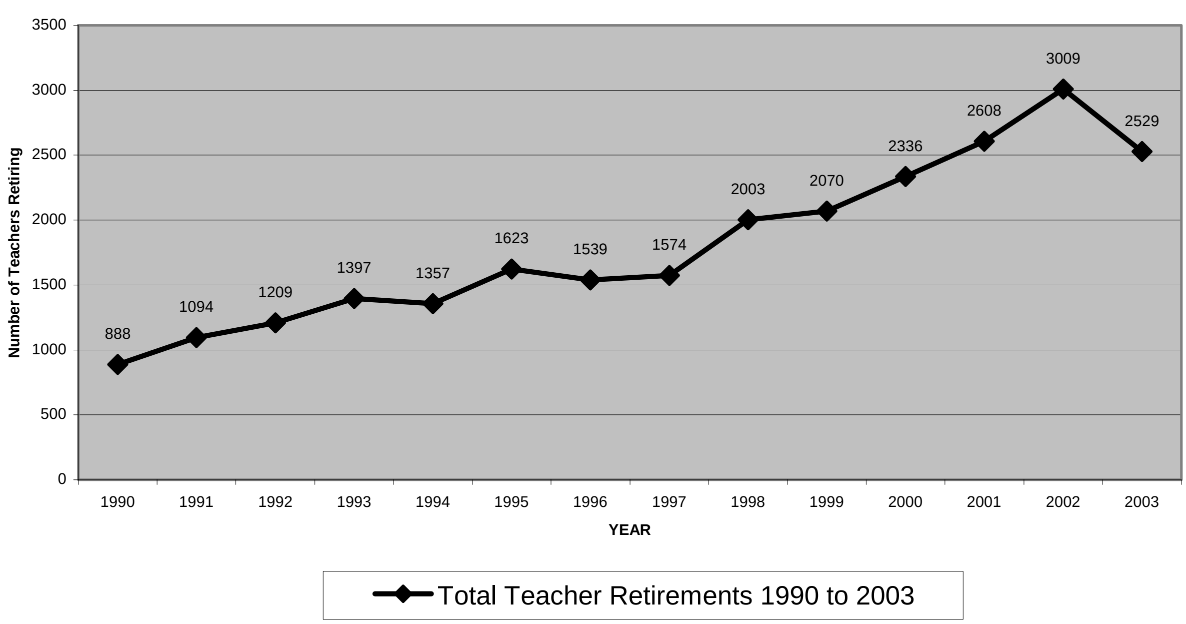
The actuary's cost estimates are based on the assumption that lifting the salary cap changes the retirement patterns of active employees. The rationale for this assumption is that lifting the salary cap serves as an incentive for an active employee to retire as soon as he or she is eligible (see Benefits of Double Dipping). If lifting the cap encourages employees to retire sooner than the actuary initially projected, then it follows that the contributions toward his or her pension throughout the employee's career will be insufficient. The costs increase each year the policy is in place because of the assumption that the longer the policy is extended, the greater the number of employees who will participate and retire early. **Appendix 3** provides the actuary's cost assumptions.

Evaluation of Retirement Rates Pre- and Post-Policy

To verify that the actuary's cost estimates were based on credible assumptions, the Retirement System analyzed the impact lifting the salary cap had on teacher retirement rates. The results of the analysis indicate that lifting the salary cap does change retirement patterns, thus generating some of the costs projected by the Retirement System's actuary.

A preliminary analysis of active teacher retirement rates indicated a substantial increase in the number of active teachers retiring after the policy was implemented in January 1999. Figure 1 depicts the trend of retirements among the active teacher population between 1990 and 2003. Over a three-year period, total active teacher retirements increased from 2,070 in 1999 to 3,009 in 2002. This represents a 45% increase in the number of active teachers retiring per year in just three years. The decline of the number of teachers retiring in 2003 parallels a decrease in retirements for all State employees in 2003.

Figure 1: Total Teacher Retirements 1990 to 2003



The Retirement System questioned whether the increase in the total number of teachers retiring since the implementation of the salary cap exemption proved causality. For example, the increased number of retirements is possibly due to an increase in the total number of teachers eligible to retire. Therefore, the Retirement System analyzed retirement eligibility among teachers to determine if the percent of eligible teachers retiring had changed.

Using data from the North Carolina Department of Public Instruction and the Retirement Systems Division, Retirement System staff analyzed how retirement rates among retirement eligible teachers had changed since the salary exemption for teachers was implemented in January 1999.

The expectation is that, if lifting the salary cap in 1999 did not have an affect on retirement rates, then the number of retirement eligible teachers who chose to retire in any given year would remain relatively unchanged. Conversely, if lifting the salary cap altered retirement rates, then the number of retirement eligible teachers who chose to retire will have increased significantly. The results of the analysis are depicted in **Figures 2 and 3** (page 19).

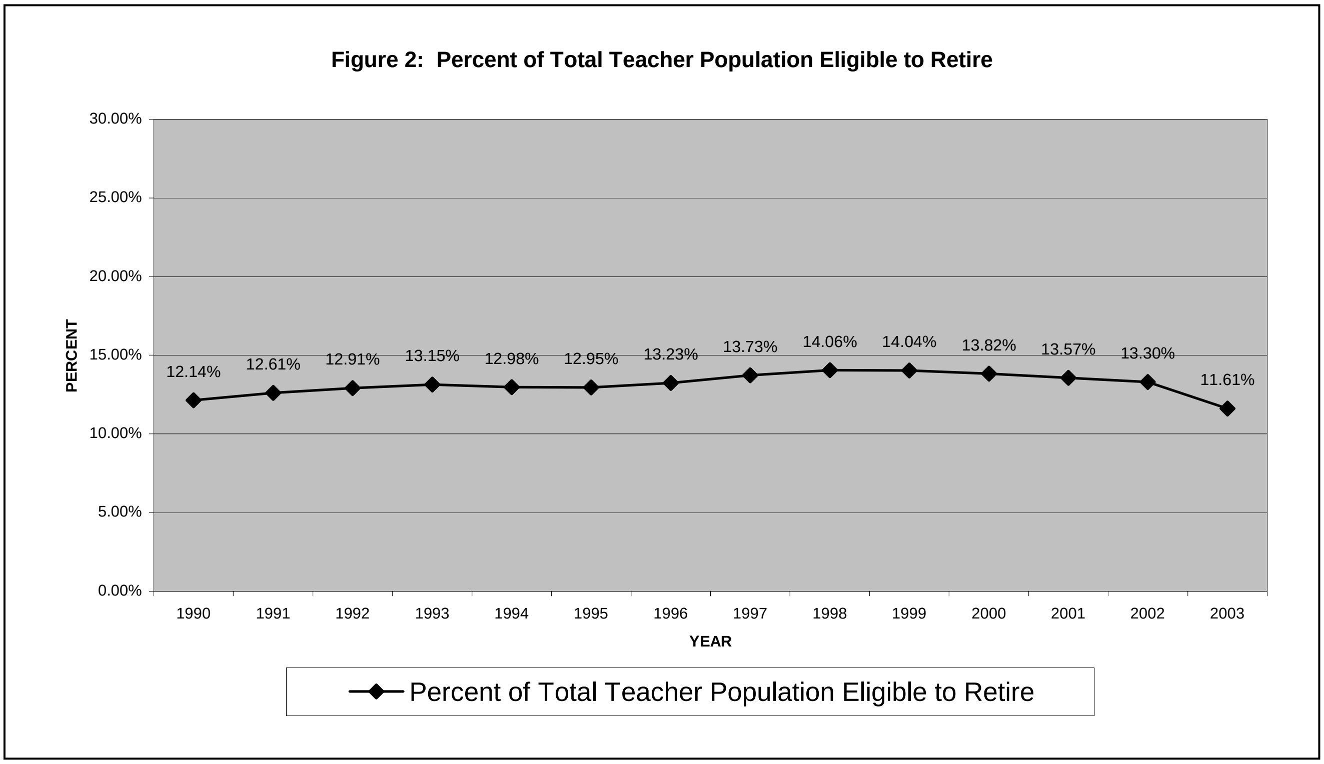


Figure 2: Percent of Total Teacher Population Eligible to Retire
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
PERCENT
12.14%
12.61%
12.91%
13.15%
12.98%
12.95%
13.23%
13.73%
14.06%
14.04%
13.82%
13.57%
13.30%
11.61%
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
YEAR
Percent of Total Teacher Population Eligible to Retire

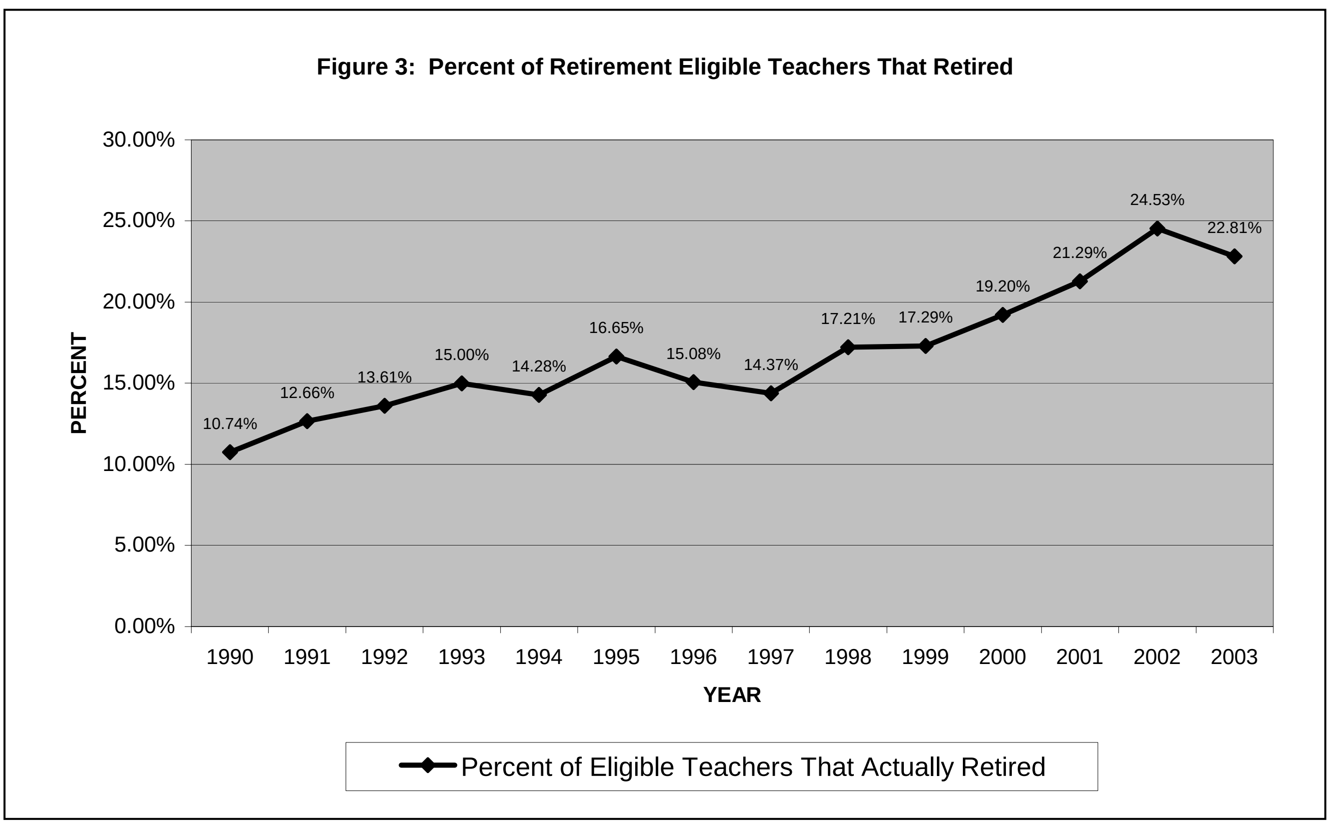


Figure 3: Percent of Retirement Eligible Teachers That Retired
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
PERCENT
10.74%
12.66%
13.61%
15.00%
14.28%
16.65%
15.08%
14.37%
17.21%
17.29%
19.20%
21.29%
24.53%
22.81%
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
YEAR
Percent of Eligible Teachers That Actually Retired

Figure 3 demonstrates a marked change in retirement patterns after 1999. The trend line for **Percent of Eligible Teachers That Actually Retired** indicates that in 1999, of the total number of teachers eligible to retire, 17.29% (2,070 teachers) chose to retire in that year. The period following implementation of the salary cap was characterized by an increase in the percent of eligible teachers who actually retired. The percent of eligible teachers who chose to retire each year increased to 19.20% (2,336 teachers) in 2000, 21.29% (2,608 teachers) in 2001, 24.53% (3,009 teachers) in 2002, and 22.81% (2,529 teachers) in 2003.

The trend line for **Percent of Total Teacher Population Eligible to Retire** in **Figure 2** further strengthens the notion that exempting teachers from the salary cap had an impact on retirement rates. **Figure 2** shows that the percent of active teachers who were eligible to retire remained relatively constant between 1990 and 2003. In fact, for the period following the 1999 implementation of the salary cap exemption, the percent of teachers eligible to retire has actually declined slightly. This indicates a magnification of the policy's effect because while the number of retirement eligible teachers who actually retired each year increased after the salary cap exemption was enacted, the number of teachers who were eligible to do so actually declined slightly during the same period.

The trends depicted in **Figures 2 and 3** provide support for the actuary's cost assumption that lifting the salary cap accelerates the rate of retirement among the eligible population. It should be recognized that modeling behavior and establishing causality is extremely difficult. However, these figures are actual retirement rates and eligibility numbers, and the change in trends since implementation of the salary cap should be taken into account before further salary cap exemptions are enacted.

<u>Implications of Further Salary Cap Exemptions</u>

If policy makers determine that a personnel shortage exists, and that raising the salary cap for retirees is the preferred method to ameliorate the shortage, then the costs to the Pension Funds generated by changing retirement patterns must be funded in order to preserve the long-term solvency of the Retirement System.

The actuarial cost projections for making the salary cap exemption for teachers permanent will rise to $28 million per year. Extending the exemption to all of State government increases the estimated costs to $75 million per year (**Table 1**, page 16).

Shortening the required period of time between retirement and returning to work from the current six months to two months, see **Table 2,** page 21, increases the estimated cost of the teacher exemption to $39 million per year. Extending it to all of State government under this scenario generates estimated costs of $105 million per year to the pension fund. North Carolina's Retirement System cannot sustain these costs without additional funding from the Legislature.

Table 2: Actuarial Cost Projections for Various Salary Cap Exemption Proposals with Two-Month Separation from Service (Annual Cost Based on $11.1 Billion Payroll), Projections calculated in April 2004

Exemption Period 2: Two Months				
		Extend Provision to:		
Group	**Permanent Exemption**	**6/30/2006**	**6/30/2007**	**6/30/2008**
Teachers	$39 Million (0.39%)	$6 Million (0.06%)	$10 Million (0.10%)	$14 Million (0.14%)
Assistant Principals	$3 Million (0.03%)	0	$1 Million (0.01%)	$1 Million (0.01%)
Central Office	$2 Million (0.02%)	0	0	$1 Million (0.01%)
Principals	$3 Million (0.03%)	0	$1 Million (0.01%)	$1 Million (0.01%)
Support Staff	$3 Million (0.03%)	0	$1 Million (0.01%)	$1 Million (0.01%)
All Others	$55 Million (0.55%)	$8 Million (0.08%)	$15 Million (0.15%)	$22 Million (0.22%)
Total	**$116 Million (1.05%)**	**$17 Million (0.15%)**	**$31 Million (0.28%)**	**$44 Million (0.40%)**

If additional salary cap exemptions are adopted, the Retirement System must receive concurrent funding to pay for these benefit enhancements. Employment benefits offered by the State, such as health and retirement, are key components to what makes public service an attractive career. The public sector generally pays lower salaries compared to the private sector, and these benefits are essential to North Carolina's ability to recruit and retain a talented and dependable workforce. Funding the promised benefits in an actuarially sound manner is a key factor in the State's efforts to attract new generations into the lower wage public sector.

V. North Carolina's Return to Work Policy and Federal Regulations

The Retirement System's evaluation of the Return to Work issue revealed that the State's current policy actually lacks critical provisions required by the Internal Revenue Code. The lacking component stems from the Internal Revenue Service policy position that in-service distributions are prohibited under the Internal Revenue Code. However, an exception to this policy exists if the retiree has had a separation from service prior to returning to work. Missing from the current policy is a *separation from service* provision for retirees who return to active service and continue to receive a pension. The tax-exempt status of North Carolina's Pension Fund is potentially at risk if the State does not incorporate a separation from service provision into the Return to Work policy.

Request for an Internal Revenue Service Private Letter Ruling

The 1999 legislation that exempted teachers from the salary cap was followed by subsequent proposals for further amendment. Among them was the recommendation to reduce the teacher's required wait period between retirement and return to work from six months to two months. Research of the proposal's feasibility revealed that the Internal Revenue Code prohibits in-service distributions (double dipping) under most all circumstances. Penalties for certain in-service distributions are levied on both individuals who receive them (see **Appendix 4** on 72(t) excise tax), and on pension systems that distribute them. However, an important exception does exist that allows retirees to receive in-service distributions when the retiree has had a legitimate bona fide separation from service and later returns to active service. The Internal Revenue Code does not specify what length of time sufficiently meets the definition of a bona fide separation from service. Consequently, the General Assembly instructed the Department of State Treasurer to seek a private letter ruling from the Internal Revenue Service asking if reducing the required separation from service from six months to two jeopardizes the tax-exempt status of the State's Pension Funds (Session Laws 2002-126, s. 28.10(a1).

Despite multiple consultations and conferences with its representatives, the Internal Revenue Service has declined to issue a ruling letter either defining a period of time that satisfies the separation from service requirement, or if two months was sufficient. However, the IRS has responded in writing to North Carolina's request. In that letter, they clarified several points and provided guidance as to what provisions the State should adopt so as to have a comprehensive Return to Work policy that is in compliance with federal regulations (see **Attachment**). The IRS points are summarized in bullet form below.

The prohibition against in-service distribution are clarified by the IRS stipulations that:

- Section 401(a) of the Internal Revenue Code defines those requirements that must be met in order to qualify as a pension plan

- Section 1.401-1(b)(1)(i) of Income Tax Regulations define a pension plan as 'a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually life, after retirement'.

- The same section specifies that a plan is not a qualified pension plan 'if it provides for the payment of benefits not customarily included in a pension plan'. Layoff benefits are an example.

- The IRS specifically asserts in the letter that 'the prohibition against in-service distributions is consistent with the purpose of a pension plan'.

- Revenue Ruling 56-693, 1956-2 C.B. 282 specifies that a pension plan fail to meet qualifying requirements if it permits employees to withdraw any funds accumulated prior to severance of employment.

- Revenue Ruling 74-254, 1974-1, C.B. 91, reinforced a ruling that distributions from the plan to an employee who had ceased participation in the plan, **but had not terminated employment**, did not satisfy the requirements of section 1.401-1(b)(1)(i) (see above)

- This ruling further held that a plan fails to qualify if it permits distributions to employees prior to **normal retirement** and prior to termination of employment.

These points demonstrate that permitting in-service distributions violates Internal Revenue Code and potentially disqualifies a pension plan's tax-exempt status. The State must avoid implementing any policy amendments that are not in compliance with the federal regulations, as the consequences of losing the plan's tax-exempt status are enormous. The loss of North Carolina's tax-exempt status would subject all of the system's income sources to federal taxes, including:

- Employer contributions
- Member pre-tax contributions
- Investment earnings

Policy makers should be aware that in-service distributions are <u>permitted</u> under certain circumstances. Two key instances are when an employee attains 'normal retirement age', or when an employee has a bona fide separation from service and is subsequently rehired.

IRS stipulates that in-service distributions are permitted once an employee has reached 'normal retirement age'. The Federal Code recognizes 'normal retirement age' as age 65. In-service distributions taken prior to achieving normal retirement age are in violation of federal regulations unless the retiree has had a legitimate separation from service.

For those retirees who have not attained the federally recognized 'normal retirement age', an in-service distribution may be permissible if the employee has incurred a legitimate separation from service before returning to work. North Carolina presently does not have a statutorily mandated separation from service.

<u>Establishing and incorporating a " bona fide separation from service" into North Carolina's Return to Work policy is the essential next step toward compliance with federal regulations</u>.

Establishing a Bona Fide Separation from Service

As indicated at the beginning of this section, the IRS had declined to issue a ruling on what constitutes a bona fide separation from service. The Retirement System staff has met and spoken via telephone multiple times with IRS representatives to discuss this issue. While they will not explicitly define a satisfactory separation from service time period, IRS contacts did provide some guidance.

Regarding the original questions in the State's request for a private letter ruling, IRS representatives have stipulated orally that a two-month separation of service would likely <u>not</u> meet their requirements. The explanation is that a leave of that or similar duration might be considered equivalent to, or indistinguishable from, a summer leave, which is customary for certain occupations; educators for example. A two-month leave would therefore not be an indication of genuine separation from service for teachers.

Given the importance of preserving the State's tax-exempt status and the IRS prohibition against in-service distributions, it is imperative that North Carolina define and implement in statute an enforceable system-wide separation from service requirement for all retirees who return to work and receive a pension before normal retirement age. The universal requirement of retirees to have a statute-defined separation from service accomplishes the following goals:

- The State is in compliance with the prohibition against in-service distributions to employees under normal retirement age
- Individuals under the age of 59 ½ who incur a bona fide separation from service, are later rehired and receive in-service annuity distributions are not subject to the 72(t) Excise Tax
- The State has potentially mitigated some of the risk to the system's tax-exempt status for allowing those under 59 ½ to return without a separation from service.

The challenge for the State is to define how long the separation from service must be without federal guidelines. The Retirement System conducted a survey to determine what periods of time peer retirement systems (State public pension systems) were using. Please see appendix x for the results of the NC Retirement System survey. Among our peers, separations from service periods vary from thirty (30) days to one year. The average separation period is approximately three (3) months. It would be ideal for the State to develop a time period that conforms to federal regulations on a rational basis. While the IRS will not issue specific guidelines, inferences can be made on the basis of the agency's advice to the Retirement System.

<u>Defining a Bona Fide Separation from Service</u>

IRS representatives have emphasized that the essential factor distinguishing a bona fide separation in service in their view is that the retiree had a genuine (demonstrated) *intent* to retire. In other words, the retiree intended to meet the definition of retirement – withdraw from active service and receive a pension as an income replacement. Employees that *technically* retire to begin receiving a pension, with the intention to then return to work are not likely meeting the IRS' definition of retirement, and therefore are violating the prohibition against in-service distributions. The IRS provided the following language clarifying this last point:

- "The determination of whether the employment relationship between an employee and the employer maintaining the plan has been severed is based upon the facts and circumstances of the specific individual situation."

further

- "Among the significant factors would be a demonstration that the employee has made an independent personal decision to permanently sever the employer/employee relationship without any *reemployment pre-arrangements*, and the employer has exercised independent business judgment in rehiring certain terminated employees."

finally

- "All facts and circumstances surrounding the employee's severance as well as the employer's decision to rehire must be evaluated in making a determination as to whether the plan is making in-service distributions."

Again, the IRS has not to this date defined what specific time period constitutes an adequate separation from service in order to be considered duly retired and then approved to return to work and earn both salary and pension. Further, periods of separation that parallel breaks in service and are typical for a given industry, for example two months summer break for educators, may not sufficiently indicate an intention to truly retire.

The Retirement System surveyed peer public retirement systems and found required separation periods ranging from 1 to 12 months, with 3.8 months being the average break in service.

On average, the longer an employee stays in retirement prior to returning to work, the more likely he or she had intended to permanently retire. Thus specifying an extreme separation period of five years nearly ensures that the test of intention would be satisfied. On the other hand, an exceptionally short amount of time carries the highest risk of being in violation of allowing an inappropriate in-service distribution. The correct period of time above the absolute minimum depends on the State's position of what defines a retirement.

If the policy is to reflect the State's definition of retirement, which is 'withdrawal from active service', then North Carolina's separation from service should serve as an incentive to when ready to do so permanently. This will not affect those that truly intend to retire, who will be free to return after their already intended permanent separation, and it will be a disincentive to those employees who are retiring in order to double dip – which is in violation of IRS regulations.

Pre-existing Reemployment Arrangements

Policy makers must consider an additional critical element while developing a comprehensive Return to Work policy. Pre-existing arrangements are viewed as an explicit indication to return to work and receive an in-service distribution, which violates the IRS code. Again, intent to retire is demonstrated when:

- "…the employee has made an independent personal decision to permanently sever the employ/employee relationship without any reemployment pre-arrangements…"

and

- "…the employer has exercised independent business judgment in rehiring certain terminated employees."

finally

- "the regulations ….specifically do not endorse a prearranged termination and rehire as constituting a full retirement."

In order to prevent future violations of federal code, the State needs to statutorily prohibit employers and employees from establishing pre-existing employment arrangements prior to retirement.

VI. Recommendations

Based upon its evaluation of the Return to Work issue, the Retirement System has developed a list of guiding recommendations that will help policy makers strengthen North Carolina's Return to Work policy. The recommendations are grouped into three categories:

A. Preserving North Carolina's Pension Funds
B. Keeping State Retirement Policies Compliant with Federal Regulations
C. Retaining Valuable Employees in the Active Workforce

Preserving North Carolina's Pension Funds

Retirement benefits play an important role in the State's ability to recruit and retain a skilled and dependable workforce. Thus, preserving the system's financial integrity for existing and future employees is essential. Those policies that create costs impacting the system's financial status need to be funded.

<u>Appropriately Fund Existing Exemptions to the Salary Cap</u>

The Retirement System's analysis of teacher retirements before and after the adoption of the salary exemption indicates that the policy accelerated the rate of retirement among teachers. This finding supports the actuary's cost assumptions and projections. Without an appropriate funding provision, the pension system is incurring unfunded costs as a result of salary cap exemptions.

Recommendation 1: The Retirement System recommends that if the existing salary exemption is to be retained, temporarily or permanently, then the costs of the exemption must be recognized and appropriately funded.

The salary cap exemption for teachers enacted in 1999 did not have a concurrent funding mechanism. Any costs generated by the policy exception were absorbed by the system's actuarial gains. Therefore, the gains used to cover the cost of the policy were not available as benefit enhancements to the general membership or as contribution reductions to the General Assembly.

In 2004, the General Assembly attached a funding component to the Salary Cap Exemption for Teaching. The new provision requires local school systems to pay the Retirement System 11.7% of salary of any retired teacher it hires. While it was adopted as a means to fund the costs of lifting the salary cap, it is not yet clear whether the 11.7% adequately covers the liability.

The following steps should be taken to effectively implement Recommendation 1.

> **A.** Consult with the Retirement System's actuary to accurately establish the total cost of the exemption and align funding provisions to these projections.

Another important issue to resolve is the funding source for the salary cap exemption: should funding come from employers who hire retirees, an appropriation from the General Assembly, or a reduction of returning retirees' salary?

> **B.** Determine the appropriate funding source, whether from individual employees or a general fund appropriation, to cover the costs of current exemption.

Finally, adjustments need to be made to the existing legislation. For example, the recently attached 11.7% funding provision had the consequence of penalizing a group of teacher retirees who do not generate additional costs to the pension fund. Retired teachers who return to work part-time do not generate the costs created by those who return exempt from the cap. However, the new funding provision does not specify an exception for retired part-time teachers. Employers must also make a contribution to the Retirement System for part-time teachers. If the school system reduces a part-time teachers' salary by the amount of the required contribution, then the part-time teacher cohort may have been unfairly penalized by the legislation.

Adoption of Additional Salary Cap Exemptions Must be Evaluated and Funded

The Retirement System's analysis of the current exemption from the salary cap revealed that salary cap exemptions involve a complex cost component that must be funded to keep the pension system financially sound. Any new exemptions to the salary cap should be evaluated with these considerations in the forefront prior to implementation.

Recommendation 2: If further salary cap exemptions are implemented for other occupation classes, then the cost to the pension system of such provisions must be recognized and appropriately funded.

The State must undertake the basic exercise of determining whether lifting the salary cap for retirees is an effective personnel strategy to reduce a worker shortage.

Recommendation 3: Conduct a study to determine if salary cap exemptions are an effective personnel strategy for reducing worker shortages. Part of this analysis should include an evaluation of participation rates among active employees - how many active employees will alter their retirement patterns if the salary cap is lifted? Initial analysis indicates that this has occurred with the teacher exemption.

Keeping North Carolina's Retirement Policy Compliant with Federal Regulations

The Retirement System determined that two courses of action must be taken to ensure that the State's retirement policies are in compliance with federal regulations:

1. Define in Statute a Required Bona Fide Separation from Service
2. Establish in Statute a Prohibition against Preexisting Employment Agreements

Define a Required Bona Fide Separation from Service in Statute

The Retirement System's evaluation of the State's current Return to Work policy revealed that the existing policy does not comply with federal regulations. Among the many regulations with which states must comply to maintain their tax-exempt status is the IRS's prohibition against in-service distributions. In-service distributions (also known as double-dipping) are defined as the receipt of a pension while also receiving a salary from the same system as an active employee.

Allowing in-service distributions violates the federal code and carries significant penalties. For North Carolina, in-service distributions potentially jeopardize the State's tax-exempt status. For individuals, in-service distributions received prior to the age of 59 ½ require a punitive excise tax of 10% in addition to normal income tax. In-service distributions can be exempt from these penalties if employees have a bona fide separation from service between the retirement and returning to work. North Carolina will mitigate the probabilities of incurring penalties for in-service distributions if a required separation from service is specified in statute.

Recommendation 4: Establish in statute a required separation from service between the time of retirement and returning to work.

It must be recognized that the shorter the period of time specified, the more likely North Carolina's compliance with the federal code will be questioned. Additionally, shorter time periods will likely lead to increased retirement rates and thus result in a more costly policy (please see Recommendations 1 - 3).

Establish a Prohibition against Preexisting Employment Agreements

Recommendation 5: Specify in statute that preexisting employment agreements between employers and employees prior to retirement are prohibited.

North Carolina's current Return to Work policy is also in danger of violating federal tax code by not prohibiting employers and employees from establishing post-retirement employment agreements before the employee retires. The IRS has informed the Retirement System that preexisting employment agreements are an indication that an employee had no intention of retiring, and instead planned to retire and return to work in order to receive an in-service distribution (which is in violation of federal code, see Recommendation 6). North Carolina can mitigate the risks of allowing prohibited in-service distributions by implementing provisions clarifying what is permissible and what is not.

Retaining Valuable Employees in the Active Workforce

Each of the preceding recommendations have focused on two parameters of the Return to Work issue that have the most immediate priority: 1) funding existing and additional salary cap exemptions, and 2) bringing the State's policy into compliance with federal regulations by defining a mandatory separation from service between retirement and returning to work.

The remaining recommendations are to establish programs and policies that will reduce the State's reliance on a Return to Work policy to achieve its personnel needs. Rather than adopting policies that provide economic incentives to retire as soon as possible, the more logical path for the State to follow is to retain in active service those retirement eligible workers with valuable skills sets and knowledge. This could be accomplished with many different strategies.

Various methods for retaining quality employees, other than return-to-work exemptions, have been implemented or proposed in other states and at the federal level. Such practices have had varying degrees of success in terms of both quality and quantity of employees retained. Some programs allow departmental management discretion over which employees are retained beyond retirement eligibility, empowering departments to retain the most valuable, productive employees. Other retention programs have been implemented that remove management empowerment because they must be available for all employees. One of the criteria North Carolina should consider when assessing retention programs is the degree of empowerment the State will have with regards to not just retaining personnel, but also the extent to which a particular program impacts worker productivity levels.

Recommendation 6: Implement Retention Programs encouraging valued employees to postpone retirement and thus help the State meet its personnel objectives. This report summarizes three possible strategies.

<u>Retention Bonuses: Retain versus Rehire</u>

Effective planning for future workforce needs and recruitment requires that North Carolina recognize that nearly every employee who leaves State employment has to be replaced. Because of this, the State incurs a significant replacement cost for each position that is vacated. Increasingly, private industry has begun to identify these expenses, incorporate them into the cost of doing business, and adopting strategies to reduce these costs by using replacement funds to retain the valuable, highly productive personnel who are the most costly to replace.

The North Carolina Office of State Personnel (OSP) has undertaken the task of evaluating the State's annual turnover rates and associated costs of recruiting and training replacements. Preliminary estimates from OSP indicate that the State's annual turnover cost may be as high as 50 percent (50%) of the position's salary.[13] Presently, these costs are not recognized by departments, and are thus 'soft' costs within departmental budgets.

The State could conceivably empower department managers to utilize some portion of these funds used to replace employees as retention bonuses for those employees who are retirement eligible, giving managers the option of paying a retirement eligible employees a bonus to postpone retirement. Clearly, strict criteria would have to be developed to ensure that retention bonuses were appropriately awarded. However, such a program could potentially reduce the State's total turnover rate, mitigate labor shortages by retaining valuable workers, and generate a net savings to the State.

[13] North Carolina Office of State Personnel provided these figures in anticipation of the imminent release of their report.

Recommendation 6A: Conduct a comprehensive analysis of the State's total employee turnover. Derive the associated turnover costs. Recognize these costs as operating expenses funded from departmental budgets. Develop a new retention program that gives department and agency management the ability to offer valued veteran employees a bonus incentive to postpone retirement.
*****The North Carolina Office of State Personnel is currently in the process of completing a report for imminent release that addresses this very issue.

<u>Phased Retirement</u>

Recommendation 6B: Evaluate and prepare for implementation of a statewide Phased Retirement program.

The United States Treasury recently released proposed regulations for a federally recognized phased retirement program. The Treasury's proposed Phased Retirement program allows eligible employees to phase into retirement by partially reducing their workload and receiving a partial in-service distribution. For example, once eligible to participate in the proposed plan, an employee could reduce his or her workload to 80%, and start receiving 20% of his or her pension. Larger reductions in workload could mean the employee would be eligible for larger portions of their pension.

As proposed, the program will have numerous conditions that will add to the program's complexity. For example, if adopted, Phased Retirement would have to be available to all employees. It would have to be voluntary. Participants will have to be eligible to retire and receive a pension, but will not be eligible to participate in Phased Retirement until reaching at least age 59 ½. Preexisting agreements will not be allowed.

If implemented under current Treasury proposals, Phased Retirement will present significant administrative challenges that must be thoroughly evaluated, documented and planned for prior to State adoption. The Retirement System is not presently equipped with staff, technology or expertise to continually recalculate and distribute partial pension distributions. Additionally, as proposed by Treasury, Phased Retirement participants will have to be allowed to continue accruing service credit. This will potentially result in multiple benefit calculations and recalculations, and distributions, for all Phased Retirement participants.

Other plan components requiring infrastructure enhancements include verification that a participating employee has reduced his or her workload. This will require a level of coordination between agencies, including State employers, the Retirement System and the Office of State Personnel, which currently does not exist.

Phased Retirement is potentially a means through which North Carolina can remain in compliance with federal codes and still retain valuable senior employees who are eligible to retire by allowing a partial in-service pension distribution. The administrative challenges will be significant and additional resources and infrastructure will be required. Further, it is likely that the program will not be available as a performance awarded program, but instead will have to be made available to all eligible employees.

Increase Accrual Rate

Recommendation 6C: Increase the accrual rate for retirement eligible employees to encourage continued service.

Another means to retain veteran, retirement eligible employees that does not involve lifting the salary cap is to implement a progressive accrual rate (retirement multiplier). Increasing the retirement multiplier will raise employee's final pension benefit, thus it is an added incentive to remain in service longer.

Presently, all State employees have the same 1.82 retirement multiplier for all years of service. For most employees, the difference in net pension benefit between working 30 years and working 31 years is relatively small. An example illustrates this point:

- Employee A works for 30 years and has a final average salary of $40,000. Employee A's pension will be $21,840.
- If Employee A works for 31 years, with the same $40,000 final average salary, the pension will be $22,568.
- The added year of service results in an additional $728 pension income per year, or, $60.66 per month.

For many veteran employees contemplating retirement or a second career, a pension increase of $60.66 per month may not be worth an additional year of service.

Alternatively, policy makers could implement a progressive accrual rate program to encourage veteran employees to remain in service additional years beyond retirement eligibility. With a progressive accrual rate feature, employees with years of service beyond retirement eligibility receive a higher multiplier. For example, the multiplier could be increased for all years of service after the 30th year. Using the same numbers from the preceding example, assume the accrual rate is increased to 2.5 for each year of service after the 30th (the standard multiplier of 1.82 will still apply to all other years of service):

- Increasing the multiplier from 1.82 to 2.5 for an employee who has worked 31 years increases the employee's pension by $1,000 for the additional year of service.
- Larger increases in net pension can be achieved by increasing the accrual rate.
- With a progressive accrual rate structure, each additional year of service beyond retirement eligibility could earn an increasingly higher accrual rate.

There are pros and cons to such a program. The primary benefit to the State is an incentive tool to retain senior, valuable employees in an environment of potential labor shortages. The cons are significant and include: choosing effective accrual rates, increased costs that must be funded through appropriations, added administrative complexity, and, as participation must be available to all eligible employees regardless of performance or productivity, management will not be able to use this incentive as a tool to retain just high performing employees.

Determining an appropriate accrual rate formula will be an initial challenge. The incentive power of increasing the accrual rate will vary among employees, as no two employees will react the same to a particular rate. An extreme increase in the accrual factor, one for example that increases the average employee's pension by $3,000 per year, will be an incentive for nearly all employees to work as long as possible. However, the costs to the State to fund such an incentive may be prohibitive. Conversely, accrual rate increases that raise an employee's annual pension only marginally may not be sufficient to alter retirement patterns and prolong service.

The added administrative complexity of a progressive accrual rate will also have to be evaluated, and the resources necessary to implement the program allocated.

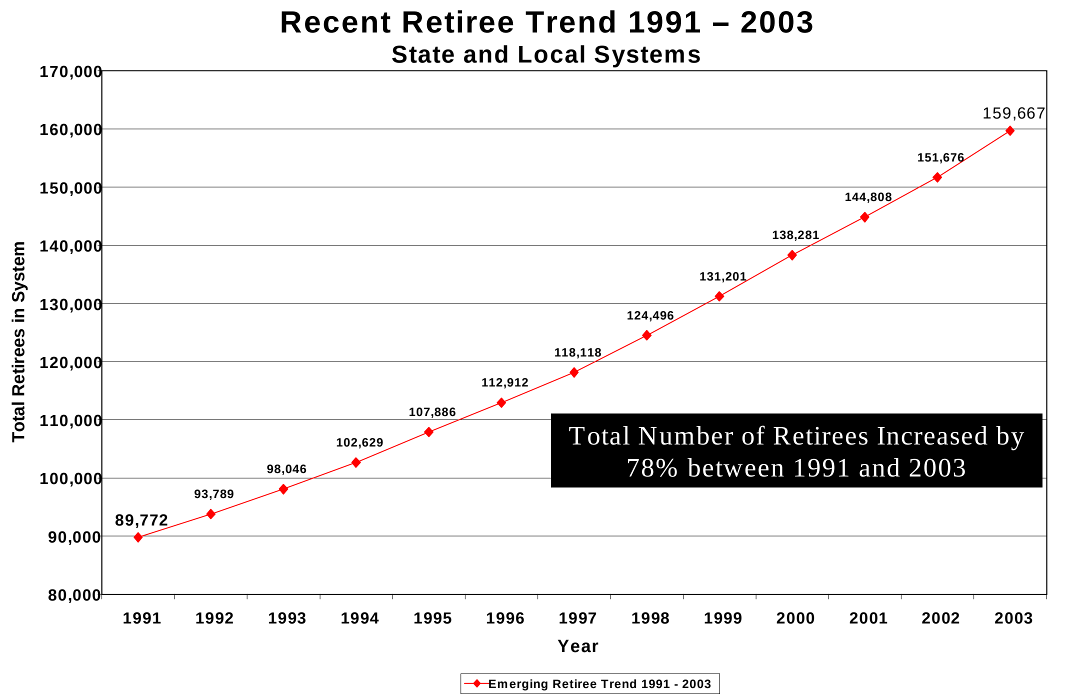
For this strategy to be effective, both in terms of the number of employees it will retain and the State's ability to afford the policy, North Carolina must first conduct a comprehensive evaluation of its current and future labor needs; and establish how many, if any, senior employees it needs to retain. That will help determine what type of progressive accrual formula should be adopted.

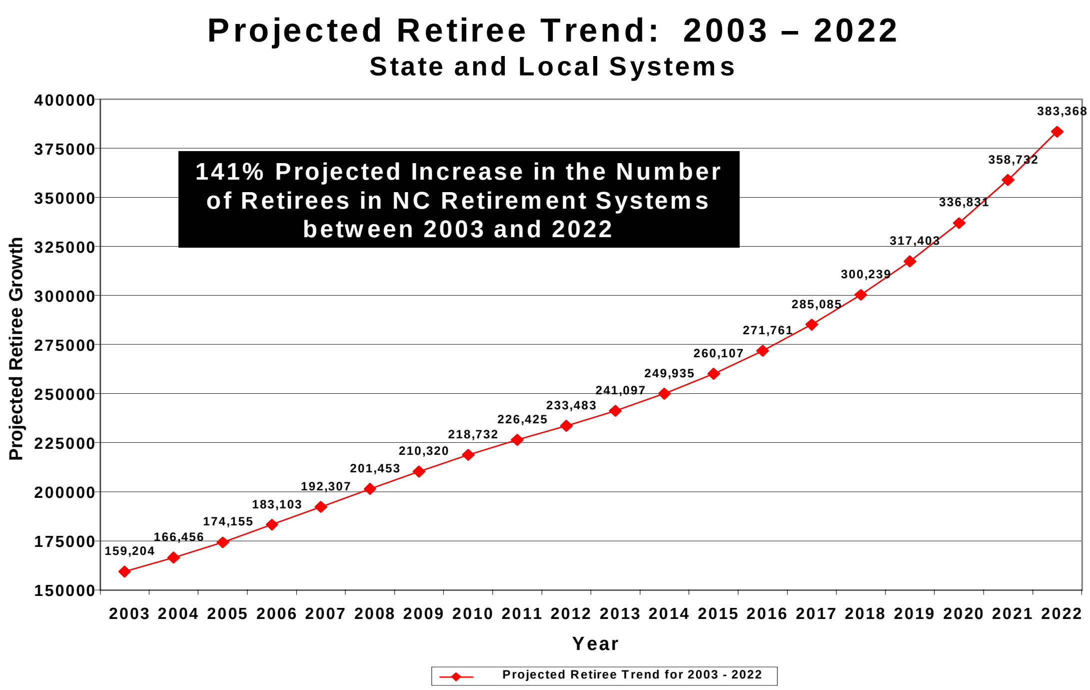
Ultimately, implementing a progressive accrual rate will increase the amount of funding required to keep the pension system actuarially sound. Other strategies that will potentially retain employees, such as increasing salaries or retention bonuses, may be more effective and more cost efficient. Further study is required to determine which method best serves the State's interests.

If these recommendations are considered and implemented it is felt that North Carolina can create a return to work policy that will maintain the strong financial health of the retirement system, keep the system in compliance with federal regulations and help generate a robust and skilled workforce that will serve the citizens of the state for decades to come.

VII. Appendices

Appendix 1: Retirement Trends





Appendix 2: Demographics

Overview

Pressure to modify the current Return to Work policy is motivated by a combination of mounting personnel shortages in certain occupational groups and the demand for employee benefit and salary increases.

Information verifying the existence and magnitude of labor shortages in North Carolina's public sector is not readily available and possibly not comprehensively understood. However, if verified, the existence of personnel shortages and legislative proposals to counteract them are most likely due primarily to major demographic trends. The transition of the Baby Boomer cohort from active employee to retirement status will significantly deplete the public sector workforce, increase the number of individuals who want to return to work, and accelerate the demand for retirement related services. While demographics alone do not provide black and white answers to key policy questions, various demographic profiles yield insight into retirement trends and personnel conditions in the State's near future.

The United States Census Bureau and the Employment Security Commission (ESC) provide North Carolina population and employment statistics revealing that over the next twenty years the State's population will continue to grow, the 'retirement age' portion of the population will soar, and employment in the public sector will increase. Further, Census Bureau statistics of the generations succeeding the Baby Boomers in the labor market provide preliminary evidence that the State may potentially experience a labor shortage for some period(s) in the future (absent significant downsizing, automation, outsourcing, etc.).

Future Labor Shortage?

Many reputable sources, including *Harvard Business Review*, cite labor shortages of approximately 10 million workers in the foreseeable future. The research that results in this opinion is based on information provided by the United States Bureau of Labor Statistics (BLS). On two occasions, however, BLS researchers stressed to Retirement System staff that this is a misinterpretation of the data. They maintain that the BLS does not support the prediction of future labor shortages because the economy is generally able to adapt to changing market conditions.

While the number of workers available in the future, and the use of the word "shortage" persists in debates among policy makers, it is true that the exit of the Baby Boomer cohort from the workforce of the United States will leave a gap in that workforce. This gap will occur because the cohort behind them is not nearly the size of the Baby Boomers. Thus, based on present numbers and predicted economic growth, there will be fewer workers in the future than at present. However, available statistics say more about population changes over time then they do about future labor market conditions.

Demographic Statistics

The transition of the Baby Boomers from active workers to retirees is a national issue that is also a concern in North Carolina. The dramatic change in the State's population profile over the next twenty years suggests potential labor issues in the future. Additionally, North Carolina's projected population growth of 13.64% between 2005 and 2025 indicates that the demand for government services is not likely to diminish.

Table 1: North Carolina's Projected Population Profile through 2025 [14]

Age Group	Increase / Decrease	Percentage Increase / Decrease
0-4	Increase	6.0%
5-17	Decrease	2.0%
18-24	Decrease	1.1%
25-64	Increase	4.7%
65 +	Increase	85.38%

As seen in this table, the population above 65 years of age will grow exponentially over the next 20 years. If growth in the 65+ group is correlated with accelerated retirement rates, then the population below 65 is not projected to grow enough to fill the void left behind in younger age groups.

Public Sector Job Growth

To discuss a shortage, it is imperative to also examine projections for the number of workers that will be needed in the future. Projected public sector employment is detailed in **Table 2**. Federal, State, and Local government employee numbers are listed for 2002, and are projected for 2010. An annualized growth rate percentage is also included.

Table 2: Projected Public Sector Job Growth[15]

	2002 Employment	2010 Employment	Annualized Growth Rate
Federal Government	45,130	45,860	0.16%
State Government	72,840	84,780	1.53%
Local Government	135,360	165,310	2.02%
Combined*	253,330	295,950	1.57%

**Statistics do not include education and hospital employees*

The statistics in Table 2 reveal that public sector employment will increase in the near future. That this expansion will occur simultaneous with the transition of Boomers into retirement adds

[14] Source: United States Census Bureau http://www.census.gov/population/projections/state/stpjpop.txt
[15] Source: North Carolina Employment Security Commission, Employment Projections by Major Industry Groups

additional weight to the possibility of a future shortage. It is important to reiterate that, as with the workforce shortage predictions above, these numbers cannot account for adjustments that the public sector will make to allow the work to get done with fewer employees.

Need for a Labor Market Study

The lesson from an analysis of demographics is that there are no certainties in predicting shortages. While there are presently not enough workers in the population to outright replace retiring Baby Boomers, the question of whether that equates into a current or future personnel shortage remains unclear. Collectively, immigration, outsourcing, downsizing and automation will be natural economic responses to changes in the labor market. North Carolina needs an in-depth evaluation of the current labor force (including projected turnover and retirement rates) that can yield forecasts for future labor needs. These findings will determine the extent to which personnel policies need to be revised or developed in order to meet the State's long-term labor needs.

Appendix 3: Actuary Assumptions of Retirement Rates Under RTW Scenarios

General Employees

Age	All Employees		Eligible for Unreduced		With Six Month Provision: Eligible for Unreduced		With Two Month Provision: Eligible for Unreduced
	Male	Female	Male	Female	Male	Female	All
50	30.00%	30.00%	50.00%	50.00%	70.00%	70.00%	90.00%
55	30.00%	35.00%	50.00%	55.00%	70.00%	75.00%	90.00%
60	20.00%	20.00%	40.00%	40.00%	60.00%	60.00%	90.00%
65	50.00%	50.00%	70.00%	70.00%	90.00%	90.00%	90.00%
69	25.00%	25.00%	45.00%	45.00%	65.00%	65.00%	90.00%

Teachers

Age	All Employees		Eligible for Unreduced		With Six Month Provision: Eligible for Unreduced		With Two Month Provision: Eligible for Unreduced
	Male	Female	Male	Female	Male	Female	All
50	25.00%	30.00%	55.00%	60.00%	75.00%	80.00%	90.00%
55	30.00%	40.00%	60.00%	70.00%	80.00%	90.00%	90.00%
60	20.00%	20.00%	50.00%	50.00%	70.00%	70.00%	90.00%
65	40.00%	40.00%	70.00%	70.00%	90.00%	90.00%	90.00%
69	20.00%	20.00%	50.00%	50.00%	70.00%	70.00%	90.00%

Law Enforcement

Age	All Employees	Eligible for Unreduced	With Six Month Provision	With Two Month Provision
				All
50	15.00%	55.00%	75.00%	90.00%
55	20.00%	60.00%	80.00%	90.00%
60	15.00%	55.00%	75.00%	90.00%
65	75.00%	100.00%	100.00%	90.00%
69	15.00%	55.00%	75.00%	90.00%

Appendix 4: IRS 72T Excise Tax

- What is 72T?
  - 72T is a 10% penalty or punitive tax, which the IRS imposes on distributions received from a retirement account before age 59 1/2
  - This penalty is applied against pension income in addition to ordinary income tax.
- Why is 72T applied?
  - 72T's purpose is to discourage workers from taking early distributions from a retirement account.
  - This disincentive helps to ensure sufficient funds will be in place for members as replacement income throughout their retirement years.
- Are there any exceptions?

Retirement distributions received before age 59 ½ will not incur the 10% penalty in the following circumstances:

1. Members have officially retired and not returned to work.
2. Members have retired and not returned to work for some period of time. In other words, there has been a "bona fide separation from service."

- What are the key issues involved with this code and return to work?

  - Retirement systems must adhere to the IRS code to maintain tax-exempt status, the loss of which would be financially devastating to a system.
  - Without exempt status, all of the system's income sources would be subject to federal taxes:
    - Employer contributions
    - Member contributions
    - Investment earnings
  - Although the IRS has not defined guidelines for a bona fide "separation from service," it has warned that retirement systems allowing an "illegitimate" separation in service before returning to work undermine IRS regulations and risk loss of their tax-exempt status.