JOINT LEGISLATIVE EDUCATION OVERSIGHT COMMITTEE – 1/11/06
And, SUBCOMMITTEE – 3/7/06
By
The North Carolina Association of Community College Presidents
Dr. Gordon Burns and Dr. Ed Wilson

The reported impetus for Senate Bill 622 was to ensure that the NC retirement system does not violate the internal revenue code which requires that there be a separation of service upon retirement. The IRS does not specify the minimum time of separation.

- According to SREB, states vary in their requirements for the period of separation. Examples of southern states are as follows:
  - Alabama – one pay period
  - Arkansas – 30 days
  - Delaware – no separation required
  - Florida – one month
  - Georgia – one month
  - Maryland – no separation required
  - Mississippi – 45 days
  - **North Carolina – 6 months**
  - South Carolina – 60 days
  - Tennessee – 60 days
  - Texas – one month
  - Virginia – 30 days
  - West Virginia - none

- **NC G.S. 135 – 1(20), Section 29.28.(h), as rewritten, reads as follows: "Retirement means the termination of employment and the complete separation from active service with no intent or agreement, express or implied, to return to service. A retirement allowance under the provisions of this Chapter may only be granted upon retirement of a member. In order for a member's retirement to become effective in any month, the member must render no service, including part-time, temporary, substitute, or contractor service, at any time during the <u>six months</u> immediately following the effective date of retirement."**

- NC's required separation clearly and significantly exceeds that required by other southern states and there appears to be no reason in federal law, policy or practice to require such a lengthy separation of service.

<u>Current Employment Environment</u>

- Nationally, 70M baby boomers are approaching retirement creating a projected workforce shortage
- NC's most experienced educators are retiring in ever greater numbers

- The NC Center for Public Research sites the shortage as an impending crisis; stating that NC must in the future hire 10K teachers per year to staff existing classrooms. The state's public and private universities produce a combined total of just over 3K teachers a year with only 2.2K of them teaching in NC.
- Community colleges, universities, and public schools all compete for the same pool of credentialed teachers
- NCCCS employs a total of 12,260 faculty, 5,380 full-time and 6,880 part-time
- Colleges and schools have chronically had difficulty filling positions in critical areas such as science and mathematics, allied health including nursing, highly technical/specialized fields, special education, etc.

Effects of the New Separation Requirement upon NC Community Colleges

- Severe brain drain with the loss of knowledge and experience
- Diminished stability and quality of its workforce
- Due to existing difficulty in filling such positions, loss of expertise in highly technical and critical positions such as payroll; accounting and finance; computer information system (CIS); financial aid; etc.
- Too few credentialed and qualified applicants for vacated positions and inability to employ experienced retirees if the search fails to identify a qualified and quality candidate
- Diminished ability to provide training and transition experiences for successors
- Increased cost resulting from employing replacement employees before the retirees retirement date (transition time)
- Loss of the efficient use of experienced part-time retirees on a temporary basis in lieu of a full-time replacement
- Added difficulty in recruiting expert part-time faculty and staff
- Inability to employ the most knowledgeable and experienced substitutes
- Loss of the mentoring of new hires by experienced retirees
- Exacerbation of the difficulty of small and medium size colleges in rural areas to assimilate a highly qualified and functioning workforce
- Elimination of the possibility of transitioning into retirement for those who dedicated their careers and lives to serve the state as educators

Recommendation:

NCACCP recommends that G.S. 135 – 1(20), Section 29.28. (h) be reconsidered and "separation" redefined as a maximum of 30 days (one pay period).

Return to Work Options
7 March 2006

Group One:
All employees subject to the earnings cap

a) Change the earnings cap to prohibit earning more than 50% of pay in any 12 consecutive months and to prohibit earning more than 60% of pay in any given month.
b) Establish a normal retirement age of 60. This would not effect the calculation of age and years of service necessary to receive an unreduced, or a reduced, retirement benefit under TSERS.
c) For employees who retire younger than normal retirement age:
    1. Prohibit pre-termination re-employment agreements; and
    2. Require a break in service of 25 working days (calculated based on the actual annual work calendar for that employee for the twelve months prior to retirement).
d) For employees who retire at or older than the normal retirement age, allow pre-termination agreements, and do not require a break in service.

Group Two:
University and Community College Faculty

a) Remove sunset from the UNC Phased Retirement Program.
    a. UNC will establish a normal retirement age (59 ½ or 60), and will limit program to faculty at or older than that age.
b) Authorize the Community Colleges to establish a similar phased retirement program for its faculty.

Group Three:
Public school classroom teachers who are exempt from the earnings cap

a) Keep six month break requirement if that is fiscally necessary and the requirement for the employing school system to contribute 11.7% of salary to TSERS.
b) During the break in service, allow them to substitute up to x [2-3] days per week
c) Develop a meaningful incentive to induce teachers not to retire after 30 years (e.g. a significant bonus that counts toward final average compensation, or an employer pre-tax contribution to a 401(k) or other deferred comp plan). Continue to work on this point.

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ISSUE: Retiree 'Return to Work' Changes

The 2005 General Assembly changed the law regarding the re-employment of retirees. The new law requires retirees with an effective retirement date of November 1, 2005 and after to have a 6-month break in service before being re-employed. During the 6-month break, the retiree shall not work in any capacity with an entity that participates in the Teachers' and State Employees' Retirement System including part-time, temporary, substitute, part-time tutor, or contractor service. This new law is creating a number of problems for public schools, which rely on retirees to return to work as teachers, administrators and in many other important roles. Some of the specific concerns raised by school administrators statewide about this new law are indicated below:

1. The six-month break that is required before re-employment is excessive, especially since many other states require a break of only one, two or three months and they have had no negative consequences from the Internal Revenue Service.

2. The length of the six-month break is causing school districts to lose some of their most experienced and dedicated personnel, especially teachers, at a time when the state already faces a severe teacher shortage and is approaching a shortage of assistant principals and principals.

3. These same personnel shortages are being exacerbated by the new law's prohibition of a retiree working in any capacity, even as a substitute teacher or a tutor, during the six-month break.

4. The new law has been interpreted to prevent retired school personnel from being employed with a private company, if that company provides any services to a school district or a state agency. This holds far-reaching, unintended consequences that seem to interfere with a retiree's right to employment in the private sector.

SOLUTIONS:

The 2006 General Assembly should revise the retiree return to work law in the following ways to benefit North Carolina's public schools and the 1.4 million students they serve:

1. **Shorten the six-month break,**

2. **Consider establishing less restrictive requirements for retirees who want to work part-time or subject to an earnings cap, and**

3. **Clarify the law to allow retirees to be employed in the private sector and paid with private funds.**

NC ASSOCIATION OF NCASA SCHOOL ADMINISTRATORS

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options which should be considered. These options would permit State and Education Entities employees to continue providing services, on a full or limited basis, following a retirement. The three groups of affected employees would be permitted to retire, begin to receive TSERS benefits and return to employment with their State employer. The "Public School Teachers Exempt Group would be exempt form the salary caps but would have the six-month break in service, modified by allowing a limited amount of substitute teaching in the interim.

The other two groups would be subject to the NRA of the respective retirement plan (including a definition of NRA for TSERS) and would have different rules apply depending upon their age at retirement. Under the University and College Faculty Phased Retirement Group, an NRA would be established for UNC's phased retirement program, which would retain its current exemption after UNC establishes a normal retirement age and limits the phased retirement program to faculty who have attained that age. Age 59½ is both the age at which an individual under Code §72(t) can begin to receive distributions from a retirement plan without paying an excise tax and the age referenced in the phased retirement proposed regulations; UNC would adopt age 59½ (or age 60) as the NRA for its employees. An actual separation from service or prohibition of pre-termination agreements for a member in the University and College Faculty Phased Retirement Group would be unnecessary if an NRA of 59 1/2 or 60 is adopted for the phased retirement program, because limiting the program to faculty who retired at or above the NRA would satisfy the federal requirements.

For those TSERS members not participating in the Public School Exempt Group or University and College Faculty Phased Retirement Program, the Appendix recommends adopting a TSERS NRA of 60 and adopting restrictions on members who retire younger than the TSERS' NRA. For those who retire younger than the normal retirement age of 60, there could be no pre-termination agreements but the member could retire and begin to receive TSERS benefits following a break in service of twenty-five working days (determined by reference to the member's actual work calendar). As with the University and College Faculty Group, if TSERS adopts an NRA of 60 to accommodate the federal requirements, a qualifying member of this who attains age 60 before retiring would not need an actual separation from service and could negotiate a pre-retirement re-employment agreement. The earnings cap would be amended to limit the amount a retiree could earn to no more than 50% of pay in any 12 consecutive months and no more than 60% of pay in any given month. In my opinion, this combination of (1) establishing a normal retirement age, (2)tightening the earnings cap, and (3) prohibiting pre-termination agreements and requiring a 25 working day separation for those under the NRA, should meet the IRS facts and circumstances test for valid retirements.

Summary

1. For members who retire at or older than the NRA, IRS approved methods are available that permit TSERS distributions to re-employed retirees. The Code and regulations indicate that employer designated NRAs are acceptable. Many employers use age 60 (or 591/2) with IRS approval. Neither imposing a six-month mandatory break in service nor prohibiting pre-termination agreements for employees who retire at or older than the NRA is necessary to maintain TSERS' favorable tax status.

2. Members who retire before attaining the NRA may begin the receive TSERS benefits if they are "retired" according to the IRS facts and circumstances test. The proposed prohibition of pre-

termination agreements together with a tightened earnings cap and with a 25 actual working day break in service should satisfy the standard for a valid retirement. Thus, TSERS should be able to rely on legitimate "facts and circumstances" tests (as permitted in existing regulations) to show a true break in service for members below the NRA.

3. The IRS interprets the Code to permit proper re-employment pre-arrangements, and specifically requires such agreements in phased retirement programs. The proposals for the University and College Faculty Group in the Appendix are consistent with the Code, regulations and IRS positions because this group would be participating in a proper phased retirement program with participation limited to those older than an appropriate NRA.

4. Slightly relaxing the six month break in service standard for the Public School Teachers Exempt Group by allowing them work as substitutes on a limited basis, while maintaining the ban on re-employment pre-arrangements, remains consistent with the Code, regulations and IRS positions in determining if a break in service has occurred.

Thus revised standards proposed by the Education Entities should eliminate any threat to TSERS' retention of its tax-exempt status while allowing the State and the Education Entities to continue to meet its employment needs.

BUCK CONSULTANTS
One Pennsylvania Plaza
New York, New York 10119-4798

February 28, 2001

Mr. Jack Pruitt
Director, Retirement Systems Division
State of North Carolina
Department of State Treasurer
325 North Salisbury Street
Raleigh, NC 27611

Dear Mr. Pruitt:

As requested, I am writing this letter to discuss the general requirements regarding distributions from a qualified defined benefit plan, such as the North Carolina Teachers' and State Employees' Retirement System (the "Retirement System").

As you know, in order for the Retirement System to retain its qualified status its provisions must comply with IRS regulations under Section 401(a) of the Internal Revenue Code (the "Code"), and the Retirement System must be administered in accordance with its provisions.

Regulations under IRC Section 401(a) generally prohibit a qualified defined benefit plan from distributing benefits to a plan participant prior to the time the participant has incurred a separation from service from the plan sponsor and all related entities. An exception to this rule exists with respect to an employee who has reached the plan's normal retirement age (generally age 65, age 55 for law enforcement officers). Only in this situation may a qualified defined benefit plan permit an employee who has not incurred a separation of service to receive an in-service distribution.

The term "separation from service" is not defined by either the Code or regulations. However, its meaning has been discussed in revenue rulings and case law. Basically, to incur a separation from service, the employee must have experienced a "bona fide termination of employment" from the employer, and the employee/employer relationship must be completed severed. For this purpose, the term "employer" would include the plan sponsor and all its related entities. Thus, in order for an employee participating in the Retirement System to be considered to have incurred a separation from service, the employee must have severed the employee/employer relationship with the state and all other employers participating in that Retirement System.

Once an employee has incurred a "bona fide termination of employment," a qualified defined benefit plan may provide that the rehired employee can continue to receive retirement benefit payments. It is imperative, however, that a "bona fide termination of employment" has occurred.

The failure to enforce this bona fide termination of employment requirement under a defined benefit plan can be very serious.

As discussed above, a bright line definition of a "bona fide termination of employment" does not exist. However, with respect to rehires, a court held that a former employee had a "bona fide termination of employment" even though he was rehired by his former employer because, at the time of his retirement, he had no intention of returning to work and was only able to return following an unforeseeable change in circumstances. Conversely, courts have held that a "bona fide termination of employment" did not occur where an employee retires and at the time of retirement is schedule to return to work as a common law employee. Simply filing an application to retire with no clear intention to permanently severe the employee/employer relationship will not be viewed a "bona fide termination of employment." Thus, if an employee who has not reached the plan's normal retirement age retires, and at the time of retirement is scheduled to return to work with the employer as a common law employee a short time later, it is highly probable that the IRS would not view this as a "bona fide termination of employment" and determine a separation of service did not occur. In that case, a distribution from the plan to this employee would be considered a disqualifying event, and the IRS could disqualify the plan, resulting in an adverse tax consequence to plan participants.

In light of the consequences of the IRS finding that an employee did not incur a separation of service, many sponsors of qualified defined benefit plans have taken a conservative stance and designed their pension plans to stop all retirement payments if an employee is rehired. However, in consideration of today's tight labor market, other plan sponsors have amended their plans to permit, under certain scenarios, a continuation of payments upon reemployment. In some of these cases, the plan sponsors have amended their defined benefit plans to provide that only in the situation where a plan participant has been separated from service for a specified period of time will the participant, upon reemployment, be able to continue to receive retirement benefit payments from the plan. These plan sponsors have attempted to create a preponderance of evidence that the employee incurred a "bona fide termination of employment" by having the required break in service be of a length long enough that the reasonable man would not have taken that action to intentionally circumvent the IRC Section 401(a) distribution rules. A period of separation of service of at least one year is commonly used. The shorter the separation from service period, the higher the chances are that the termination from employment would not be viewed as bona fide. In a few situations, I have seen plans use shorter periods of time such as 90 or 180 days. These separation from service time rules are useful to prevent a teacher who leaves school when classes end in May and returns at the start of the following school year in September from claiming that the summer was really a termination of employment.

It should be kept in mind that the determination of whether an employee has incurred a "bona fide termination of employment" is determined on a facts-and-circumstances basis. For example, as discussed above, in the situation of a teacher who generally has a break from employment each summer and who retires at the end of one school year only to be rehired a few months later at the beginning of the next school year, it could be extremely difficult for the plan sponsor to show that this was a bona fide termination of employment.

The issues surrounding the reemployment of former employees are being confronted by many plan sponsors today. Establishing a bright line test by allowing only rehires who have had a break in service of a specified number of months to continue to receive plan payments upon reemployment will be subject to IRS review. It should be kept in mind that the shorter the period of separation, the higher the probability that the IRS, upon review, could determine a separation from service did not occur, especially where essentially the same job awaits the retiree upon rehire. As discussed above, any such finding could result in the plan's disqualification.

Of course, as you know, our views are subject to the opinion of counsel. If you have any questions, please do not hesitate to call.

Very truly yours,

Deborah Schmieder
Principal and Benefit Consultant

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cc: Mr. S. Moore

STATE OF NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
RETIREMENT SYSTEMS DIVISION

RICHARD H. MOORE
TREASURER

MICHAEL WILLIAMSON
DEPUTY TREASURER

January 31, 2003

Employees Plans
Internal Revenue Service
Commissioner (TE/GE)
Attention: T:EP:RA
PO Box 27063
McPherson Station
Washington, DC 20038

Re: Expeditious Handling of Requested Ruling

Dear Sir or Madam:

We hereby request that the enclosed letter ruling request regarding IRS Regulation Section 1.401-1(b)(1)(i) receive expeditious handling and, therefore, be processed ahead of the regular order. We are requesting this expeditious handling in light of the fact that certain applications received by the Plan Administrator of the North Carolina Retirement System for Teachers and State Employees for commencement of payment will not be processed until this issue is clarified.

It is imperative that this issue be clarified as soon as possible as the North Carolina Retirement System for Teachers and State Employees needs to know whether its status as a qualified plan will be adversely affected if payments are made to certain former members.

If there is anything further we can do to expedite this matter, please contact me at (919) 508-5377.

Very truly yours,

Michael Willamson
Director, Retirement Systems Division

Enclosure

325 NORTH SALISBURY STREET • RALEIGH, NORTH CAROLINA 27603-1385
Courier #56-20-45 • Telephone: (919) 733-4191 • Fax: (919) 508-5350

STATE OF NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
RETIREMENT SYSTEMS DIVISION

RICHARD H. MOORE
TREASURER

MICHAEL WILLIAMSON
DEPUTY TREASURER

January 31, 2003

Internal Revenue Service
Commissioner, TE/GE
Attention: T:EP:RA
PO Box 27063
McPherson Station
Washington, DC 20038

Re: Sections 401(a) of the Internal Revenue Code

Dear Sir or Madam:

The State of North Carolina ("State") hereby requests your ruling under Sections 401(a) of the Internal Revenue Code of 1986, as amended ("Code"), concerning whether certain employees have terminated employment and are, therefore, entitled to commence receiving their retirement allowance payments from the Retirement System for Teachers and State Employees ("Plan") and then continue payment of these retirement benefits upon their reemployment with the State of North Carolina or any of its eligible departments, bureaus, institutions, or political subdivisions participating in the Plan.

STATEMENT OF FACTS

Pursuant to state statute, the State of North Carolina established the Retirement System for Teachers and State Employees of North Carolina ("Plan") for the purpose of providing retirement benefits and other benefits for the employees of the State of North Carolina and any of its eligible participating departments, bureaus, institutions, or political subdivisions (the "Employer"). The Plan is a contributory defined benefit plan, which is intended to, and does, meet the requirements of a qualified plan under Section 401(a) of the Code, as applicable to a governmental plan, as defined in Section 414(d) of the Code, and its related trust is exempt from taxation under Section 501 of the Code.

The Plan provides benefits to employees of many different participating departments, bureaus, institutions, and political subdivisions of the State of North Carolina. Under the terms of the Plan, a plan member is eligible to receive a monthly retirement allowance if the member retires after he or she has met the age and/or service requirements for a retirement allowance as set forth in Section 135 of the North Carolina General Statute ("GS"). A member who retires after the completion of 30 years of creditable service is entitled to an unreduced early retirement allowance. "Retirement" under the Plan is defined in GS Section 135-1(20) as the withdrawal from active service. GS Section 135-1(20) goes on to state that in order for a member's retirement to be effective in any month, the member must render no service at any time during that month. If a member is reemployed as an employee of an Employer, GS Section 135-3(8d)

provides that generally such employee's retirement allowance payments shall cease and such employee shall become an active member of the Plan on his or her reemployment date.

However, Section 135-3(8c) provides two exceptions to this rule restricting the payment of retirement benefits upon reemployment. These exceptions apply to a member who is reemployed (i) on other than a permanent full-time basis or (ii) as a teacher. The first exception provides that if a former member retires on an early or service retirement allowance and such member is later reemployed or otherwise engaged to perform services by an Employer on a part-time, temporary, interim, or fee-for-service basis (i.e., in a "noncovered position"), such former member shall continue to receive his or her retirement allowance payments until he or she earns during the 12-month period immediately following the effective date of his or her retirement or in any calendar year thereafter, an amount from an Employer which exceeds 50% of such member's reported income during the 12-month period immediately preceding his or her retirement or $20,000, if greater ("the post-retirement threshold amount"). Once the member's earnings exceed the post-retirement threshold amount his or her retirement allowance payments are suspended for the remainder of the calendar year. In such case, the member's retirement allowance payments recommence as of the first day of each subsequent calendar year until the member's earnings from an Employer exceed the post-retirement threshold amount.

The second exception applies when a member has been retired for a minimum number of months (as set forth in the General Statute) and is reemployed as a classroom teacher. If prior to his or her reemployment as a classroom teacher, the member has not been employed by an Employer in any capacity, except as a substitute teacher or part-time tutor with a public school, his or her earnings from an Employer after reemployment as a teacher in a public school will not be included in the computation of the post-retirement threshold amount.

Over the last few years, the available pool of experienced teachers in North Carolina has become, with each passing year, smaller and smaller. As a result of this growing shortage of experienced teachers, the North Carolina General Assembly amended the state statute in 2001 to permit a former member who is reemployed as a public school teacher after a period of six or more months have elapsed between the effective date of his or her retirement and the date he or she is reemployed to continue to receive retirement allowance payments during the period of reemployment. (Prior to that amendment, the minimum period of retirement a teacher needed to incur in order to continue receiving pension payments upon reemployment was 12 months.) With the teacher shortage worsening and the need for such teachers growing because of the increase in school population, the General Assembly now has proposed shortening the period between the date of retirement and date of reemployment from a period of six months to a period of two months subject to the amendment not adversely affecting the qualified status of the Plan. Consequently, the General Assembly has passed legislation requiring the State Treasurer's Office, in its capacity as Plan Administrator of the Plan, to submit a ruling request to the Internal Revenue Service for a determination as to (i) whether a member has incurred a bonafide termination of employment even though there is subsequent reemployment and is, therefore, entitled to receive a pension payment from the Plan and (ii) whether the qualified status of the Plan is jeopardized by the proposed amendment which shortens from six months to two months

the period during which a teacher must be retired before he or she can return to work and continue to receive his or her retirement allowance payments.

The following scenarios outline four typical situations to which the state statute and proposed amendment would apply:

SCENARIO 1

Member A is a teacher age 53 who resigns from her position during the school year in January of 2004 after completing 30 years of creditable service with the State. Her previous employer then fills her position and does not promise to hold any other position open for Member A. Since Member A performs no service for an Employer in the month following her resignation, the Plan provides payments of her retirement allowance will commence in February of 2004. At the time of resignation or at the time payment commences, Member A has no verbal or written commitment or promise to return to employment with the State or any of its political subdivisions in the near future. However, in March of 2004, Member A is contacted by (or contacts) her previous employer or another employer participating in the Plan regarding a teaching position beginning in mid-April. Member A accepts the position in April. Since the position is a teaching position, and Member A was retired for more than two months (February 1 to April 14), under the proposed amendment, Member A would be able to continue to receive her retirement allowance payments during her period of reemployment.

SCENARIO 2

Since the majority of teachers retire in June at the end of the school year, Member B, who is 53 years old with 30 years of creditable service, resigns his teaching position in June of 2003. His teaching position for the 2003/2004 school year is filled by the school district with another person. At the time of the Member's resignation and also on the effective date of his retirement (July 1, 2003), Member B has no verbal or written commitment to fill any other teaching position in that school district, or any other North Carolina school district in the fall of 2003 or later, and the Employer has not promised to hold any other position open for Member B. Member B does not teach summer school and is not employed in any capacity by an Employer during the months of July and August. Also, as of the effective date of the Member's retirement, no verbal promise of any future reemployment with an Employer participating in the Plan has been made to Member B, nor has Member B had any discussions with the State or any of its political subdivisions regarding any other employment position. In light of the fact that Member B has not performed services for an Employer in the month following his resignation, in accordance with the Plan's provisions, his retirement allowance payments commence as of July of 2003. In August of 2003, Member B is contacted by (or contacts) his previous employer, another North Carolina school district, or another Employer participating in the Plan to consider applying for a teaching position other than the position he retired from in June 2003. Member B then accepts a teaching position beginning as earlier as September of 2003. Under the proposed amendment, the Plan would permit Member B to continue receiving payment of his retirement allowance

since Member B is reemployed as a teacher and was retired for at least two months (i.e., July and August) prior to his reemployment in September.

SCENARIO 3

Member C resigns from her teaching position in June of 2004 at the end of the school year at age 53 with 30 years of creditable service. Member C does not teach or perform any type of service for an Employer in July and August. The school district fills her teaching position for the school year beginning in August of 2004 with another teacher. In June, Member C is notified of another teaching position for the 2004/2005 school year in a North Carolina public school. She refuses the job, which would commence in August of 2004. However, the school district and Member C agree that she will fill the position in September of 2004. Since Member C resigned and did not perform services for an Employer during the month following her resignation, payment of her retirement allowance will commence in accordance with the provisions of the Plan in July of 2004.

SCENARIO 4

Member D resigns his full-time employment position as an administrator of a public school in mid-September of 2003 at age 53 with 30 years of creditable service. Member D, however, is then offered and accepts a temporary or part-time position with the same Employer. Since Member D has terminated employment and is then reemployed on other than a permanent full-time basis (i.e., in a position that is not eligible to participate in the Retirement System), could the Retirement System commence his retirement allowance payments, subject to the State statute's provisions regarding the member receiving earnings in excess of the post-retirement threshold amount?

RULINGS REQUESTED

Based on the foregoing facts and representations, we request the following rulings:

(1) The commencement and continuation of retirement allowance payments from the Plan to Member A, Member B, and Member C each who terminate employment and are later reemployed under the fact patterns set forth above will be considered to be made on account of their severance of employment within the meaning of Code Section 401(a) and, therefore, will not adversely affect the qualified status of the Plan.

(2) That a bonafide termination of employment has occurred and Member D under the fact pattern set forth in this ruling has incurred a severance of employment within the meaning of Code Section 401(a) and therefore, the commencement of retirement allowance payments to Member D from the Plan will not adversely affect the qualified status of the Plan.

STATEMENT OF LAW, ANALYSIS AND CONCLUSION

Section 1.401-1(b)(1)(i) of the Treasury regulations provides that a pension plan which is qualified under Section 401(a) of the Internal Revenue Code is a plan established and maintained primarily to provide for the payment of benefits to a participant after retirement. Thus, until retirement has occurred, no benefits may be distributed from a qualified pension plan. Rev. Ruling 56-693, 1956-2, C.B. 282 addresses the issue of when a qualified pension plan may provide retirement benefit payments prior to normal retirement. The ruling states that a defined benefit plan that permits the withdrawal of funds by a participant prior to any severance of employment (e.g., retirement, disability, or death) or plan termination would fail to qualify under Section 401(a) of the Code. Rev. Ruling 69-421 states that a pension plan must not permit a participant prior to severance of employment or termination of employment to withdraw any amounts attributable to employer contributions that have accumulated on his or her behalf under the plan. Rev. Ruling 74-254, 1974-1, C.B. 91 amplifies Rev. Ruling 56-693 and addresses the issue of whether a pension plan could permit a plan participant who was no longer eligible to actively participate in the plan to withdraw his or her plan benefits, even though the participant has not terminated employment with the plan sponsor. This ruling states that a participant who transfers to a position where he or she is no longer eligible to participate in the plan but remains employed by the employer sponsoring the plan has not incurred a termination of employment. The ruling further states that a pension plan that permits a participant to receive a distribution from the plan prior to his or her attaining the plan's normal retirement or prior to his or her termination of employment or the termination of the plan would not be qualified under Section 401(a) of the Code. The Internal Revenue Service has, therefore, held in various rulings that severance of employment by an plan participant is required under the provisions of Treasury Regulations Section 1.401-1(b)(1)(i) for such participant to commence receiving payments from a defined benefit plan.

Under the fact patterns outlined above, Member A resigns during the school year and her teaching position is then filled by the Employer. At the time of Member A's resignation and the commencement of her retirement allowance payments from the Plan, there are no written or verbal commitments or promises by Member A to return to work for an Employer. Member A's retirement in January during the middle of the school year evidences her intent to completely sever her employment relationship. In addition, the fact that her teaching position is filled by another and neither the Employer has promised to hold a position open for her nor has she made an oral or written commitment to return to work further evidences her employment relationship with the Employer has terminated. Therefore, she should be eligible to commence payments from the Plan in February of 2004 in accordance with the provisions of Treasury regulation 1.401-1(b)(1)(i). Member B, who resigns his teaching position in June at the end of the school year, does not perform any services for an Employer in July or August and also has not made or received an oral or written promise or commitment to return to work for an Employer at the time payments commence. The fact that a teacher is generally not scheduled to work during the month of July and most of August should have no bearing on whether or not Member B has incurred a bonafide termination of employment. At the time of his resignation, Member B has no

intention of reemployment, and the Employer has not held a position open for Member B. In addition, Member B does not return to a teaching position at the beginning of the school year. If at the time of his termination and the commencement of payments Member B's former position is being filled by another teacher, coupled with the fact there has been neither (i) an oral promise or (ii) a written or oral commitment for Member B to return to work, nor has the Employer held open a position for the Member at the end of the summer break, Member B should be considered to have incurred a bonafide termination of employment on his last day worked in accordance with the provisions of Treasury regulation 1.401-1(b)(1)(i). Thus, he is entitled to commence payments under the Plan in July. Circumstances can change after a Member retires. As long as at least two months transpire prior to reemployment, the time of year a member retires should not negate the fact that each incurred a bonafide termination when he or she resigned. Member A did not perform services for an Employer for two months following her date of resignation. Member B did not perform services for the months of July and August and did not resume employment at the beginning of school in August. At the time of termination and at commencement of payments, neither Member A nor Member B had made an oral or written commitment or oral promise to return to work, nor had the Employer offered to keep a job open. Thus, both Members A and B have incurred a termination of employment and are entitled to continue payments of their retirement allowance from the Plan.

With respect to Member C, she resigns her teaching position in June of 2004 and before her plan payments commence in July of 2004, she is contacted regarding a different teaching position in a school district beginning in August of 2004 (the start of the new school year). Member C declines the position. However, she agrees to return to work in September of 2004. Member C is not employed by an Employer in the month of July and is, therefore, under the Plan's provisions, eligible to begin receiving her retirement allowance payments in July of 2004. Thus, whether or not Member C is reemployed in September of 2004 should have no bearing on the determination of whether or not she has incurred a severance of employment at the time of her resignation. As outlined above, the IRS has numerous times stated that the grounds under Treasury regulation 1.401-1(b)(i)(1) for commencement of a distribution from a qualified pension plan is severance of employment. Member C terminated employment in June of 2004, and she agrees to return to work in a different teaching position in a school district in September of 2004. During the two months between her resignation and her proposed date of reemployment, many different events could occur outside the control of the two parties, which would result in Member C not returning to work. Thus, the fact that Member C intends to work in September of 2004 should not negate the fact that she resigned her position in June of 2004 and should not prevent her from commencing retirement allowance payments in July of 2004.

Member D resigns his administrative position with an Employer in September of 2003. However, a day later, Member D is offered and agrees to work in a part-time or temporary full-time position for an Employer, which pursuant to the state statute is a position where he is not eligible for Plan coverage. Can Member D, who resigns his full-time position, but who is then immediately reemployed by an Employer (in a position which is not eligible to participate in the Plan) prior to the date his retirement allowance payments are scheduled to begin, be treated as incurring a severance of employment and, therefore, be eligible to commence payment of his

retirement allowance without jeopardizing the qualified status of the plan? Alternatively, if Member D resigns his full-time position and is reemployed on a part-time or temporary basis at least 30 or more days after his last day worked, would he then be considered to have incurred a bonafide termination of employment and, therefore, subject to the provisions of the State statue, be entitled to commence payment of his retirement allowance? These situations can be differentiated from the fact pattern set forth in Rev. Ruling 74-254. In each case, the member resigns his full-time position with the Employer. Member D's full-time employment is actually severed. The next day he is offered, and he agrees to return to work for the Employer in a part-time or temporary position, or a period of 30 days or more elapses before he is offered and accepts another position with the Employer. Under Rev. Ruling 74-254, the employee neither resigns his position nor severs employment. He transfers from a covered plan position to a non-covered plan position without a severance from service. Therefore, he has not met the requirements of Section 1.401-1(b)(1)(i) of the Treasury regulations. In both cases, Member D has severed employment with the Employer, and therefore should be entitled, pursuant to the provisions of Section 1.401-1(b)(1)(i) of the Treasury regulations, to receive payment of his retirement allowance, without adversely affecting the qualified status of the Plan.

As discussed above, various rulings by the Internal Revenue Service have held that severance of employment by a member is grounds for a member to commence receiving payments from a pension plan. Accordingly, based on the above, the requested rulings should be granted.

IDENTIFYING PROVISIONS

North Carolina Department of State Treasurer
Retirement Systems Division
325 North Salisbury Street
Raleigh, NC 27611

Telephone Number: (919) 508-5377

EIN: 56-6118072

Key District Director: Atlanta, Georgia

ADDITIONAL INFORMATION

Although the Employee Plans Technical office will not ordinarily issue rulings on matters involving a plan's qualified status under Section 401 of the Code, the Employer requests that a ruling be issued in light of the fact the subject of this ruling request (i) is an issue that is not addressed through the determination letter process and (ii) as discussed above, is a matter that is unique and requires immediate guidance.

To the best knowledge of the Employer and its representatives, the same issue which is the subject of the ruling requested in this letter is not in an earlier return of the Employer or a related party.

To the best knowledge of the Employer and its representatives, (i) the same or similar issue has not been ruled on by the Internal Revenue Service for the Employer, a related party, or a predecessor thereof, (ii) the Employer, a related party, a predecessor or any representatives thereof has not previously submitted the same or similar issues to the Internal Revenue Service but withdrawn it before a letter ruling was issued, (iii) the Employer, a related party or predecessor thereof has not previously submitted the same or similar issues to the Internal Revenue Service that is currently pending with the Service or (iv) the Employer or any of its representatives is not presently submitting another request involving the same or similar issue to the Service.

The Employer believes that the law in connection with the request is not uncertain and the issue is adequately addressed by the relevant authorities cited above.

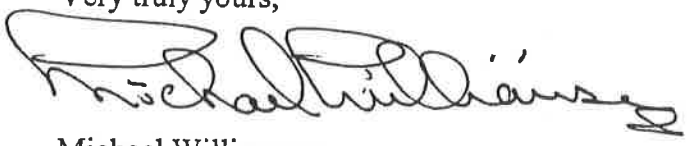
The Employer is not aware of any legislation, pending legislation, tax treaties, court decisions, regulations, revenue rulings, revenue procedures or announcements that are contrary to the position advanced by the Employer.

In connection with this request, please find enclosed a true copy of the Retirement Systems and the mandate included in the Appropriations Act. In addition, a verification statement signed by me, as Director of the Retirement System Division of the North Carolina Department of State Treasurer, the statement required under Section 6110 of the Code and the checklist required by Revenue Procedure 2003-4 are enclosed. We have also enclosed a check in the amount of $2,470 to cover the user fee required under Revenue Procedure 2003-8.

In the event you do not propose to issue the rulings requested, a conference is requested before any such action is taken.

If there is anything we can do to expedite this matter, please contact the undersigned at (919) 508-5377.

Very truly yours,



Michael Williamson
Director, Retirement Systems Division

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JAN 26 2005

Mr. Michael Williamson
Director, Retirement Systems Division
State of North Carolina
Department of State Treasurer
3205 North Salisbury Street
Raleigh, North Carolina 27603-1385

Dear Mr. Williamson:

This is response to your ruling request dated January 31, 2003, which was submitted on behalf of the North Carolina Retirement System for Teachers and State Employees concerning whether certain employees have terminated employment and are, therefore, entitled to commence receiving their retirement allowance payments from the plan and continue receiving payment of these retirement benefits upon their reemployment with North Carolina or any of its eligible departments, bureaus, institutions or political subdivisions participating in the Plan.

Under section 8.01 of Revenue Procedure 2005-4, 2005-1 I.R.B. 128 (January 3, 2005), the Internal Revenue Service will not issue a ruling letter because of the factual nature of the problem involved. Accordingly, as discussed in our telephone conversation on November 23, 2004, no further action will be taken on your requested ruling because of the factual nature of the issue involved.

Although we will not rule on this matter at this time, the following general information may be of assistance to you.

Section 401(a) of the Internal Revenue Code of 1986, as amended, prescribes the requirements which must be met for qualification of a pension, profit-sharing, or stock bonus plan.

Section 1.401-1(b)(1)(i) of the Income Tax Regulations provides that a pension plan within the meaning of section 401(a) of the Code, is 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 for life, after retirement. The regulations provide further, however, that a plan is not a pension plan if it provides for the payment of benefits not

customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses, except as described in section 401(h). The prohibition against in-service distributions in a pension plan is consistent with the purpose of a pension plan, i.e., to provide, primarily, retirement benefits at retirement.

Revenue Ruling 56-693, 1956-2 C.B. 282, as modified by Rev. Rul. 60-323, 1960-2 C.B. 148, holds that a pension plan fails to meet the requirements for qualification under section 401(a) of the Code if it permits employees to withdraw prior to normal retirement any part of the funds accumulated on their behalf which consist of employer contributions or increments thereon prior to the severance of employment or the termination of the plan.

Revenue Ruling 74-254, 1974-1, C.B. 91, reinforced the holding in Rev.Rul. 56-393. That ruling held that the payment of an annuity or lump-sum distribution from employer contributions when an employee ceased participation in the plan but continued in employment with the employer did not satisfy the requirements of section 1.401-1(b)(1)(i) and that a pension plan fails to qualify under section 401(a) if it permits distributions prior to normal retirement and prior to termination of employment or termination of the plan.

Section 411(a)(8) of the Code defines "normal retirement age" as the earlier of (1) the time a plan participant attains normal retirement under the plan, or (2) the later of (a) the time a participant attains age 65, or (b) the tenth anniversary of the time a plan participant commences participation in the plan.

Rev.Rul. 71-24, 1971-1 C.B. 114, provides that normal retirement age is the time from which definitely determinable benefits under a pension plan become fixed and payable. An employee who has reached such age and has fulfilled the service requirement and other uniformly applicable provisions of the plan must be permitted to retire and to commence receiving the benefits payable thereunder. Arrangements, however, may be mutually made for continued employment beyond normal retirement age. In such event, provision may be made with respect to the treatment of the pension benefits such as, for example, payment as though the employee had actually retired, deferment to actual retirement without increment for the interval between the normal retirement date and actual retirement, or actuarial equivalent on actual retirement of the benefit at normal retirement age. Whatever provisions are made, however, must be uniformly applied to all participants.

Rev. Rul. 71-147, 1971-1 C. B. 116 provides that ordinarily the normal retirement age under a pension or annuity plan is the lowest age specified in the plan at which the employee has the right to retire without the consent of the employer and receive retirement benefits based on service to date of retirement at the full rate set forth in the plan. Ordinarily, the normal retirement age under pension and annuity plans is 65, but a different age may be specified provided

that if it is lower than 65 it represents the age at which employees retire in the particular company or industry and is not a device to accelerate funding. This revenue ruling was subsequently modified by Rev.Rul. 78-120, 1978-1 C.B. 117 and superseded by Rev.Rul. 80-276, 1980-1 C.B. 276. In both of those rulings, changes were made in view of the enactment of the Employee Retirement Income Security Act of 1974 to allow an employer to designate a normal retirement age. Thus, an employer may designate a normal retirement age which is representative of the particular industry or company as long as the normal retirement age is not a subterfuge to avoid the prohibition against in-service distributions. This position has been reiterated in the Preamble to the Proposed Regulations found at 69 Fed.Reg.65108 (Nov. 10, 2004) ("Proposed Regulations") dealing with distributions from a pension plan under a phased retirement program.

Under section 72(t) a taxpayer who receives a distribution from a qualified retirement plan, is subject to an additional tax equal to 10% of the portion of any such distribution which is includible in gross income. Pertinent exceptions include distributions which are (1) made on or after the date on which the employee attains age 59 1/2, (2) part of a series of substantially equal periodic payments beginning after the employee separates from service or (3) made to an employee after separation from service after attainment of age 55.

The Proposed Regulations would permit the payment of certain benefits to employees who are at or near eligibility for retirement even where there has not been a separation from service. However, the Proposed Regulations at section 1.401(a)-3(c)(2) limit the payment of phased retirement benefits to employees who have attained age 59 1/2 since, under section 72(t) of the Code, employees who receive distributions prior to age 59 1/2 (even though the plan may provide for a younger retirement age) will be subject to the additional section 72(t) tax if there has not been a separation from service (see the preamble to Proposed Regulations cited above at p. 65110).

In addition to distributions upon normal retirement age, section 1.401-1(b)(1)(i) permits distributions when the employment relationship between an employee and the employer maintaining a pension plan is severed before the employee retires. 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. 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 that the employer has exercised independent business judgment in rehiring certain terminated employees. 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. In this regard, the preamble to the Proposed Regulations provides

that the regulations "do not address when a full retirement occurs and specifically do not endorse a prearranged termination and rehire as constituting a full retirement." (see p. 65110)

We hope this general information is of assistance to you. This is not a ruling, however, and may not be relied on as such.

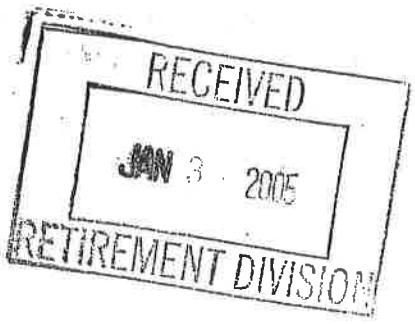
A refund check for the user fee paid for this request will be issued under separate cover. The check will be made payable to the person or entity whose name appeared on the check or money order submitted for payment of the user fee.

If you have any questions, please contact me at (202) 283-9626.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3



Concerns Relating to The Changes in The Law Regarding The Re-employment of Retirees

- Adds to the brain drain because it is harder to retain the expertise of experienced and knowledgeable employees
- Diminishes the stability and quality of the workforce
- Because a retiree can't work in any capacity during the break, it becomes harder to hire an experienced retiree to fill in on a part-time or full-time basis until a permanent employee is hired thereby exacerbating personnel shortages and increasing costs
- Decreases the opportunities for retiring employees to provide training and mentoring for their successors
- Eliminates the possibility of an employee from transitioning into retirement
- The IRS does not have a prohibition on pre-termination agreements when there is a "normal" retirement age and the employee is at or above that age
- Employers are losing retirees to other states with shorter breaks in service
- The new law has been interpreted to prevent retirees from working for private companies that provide any services to a State agency or school district during the break in service
- Law is more restrictive than necessary to comply with federal law
- The 6-month break in service is excessive compared to other states

Recommendations to the Committee

- Adopt an exception to allow a retired employee to return for a limited period of time to provide transitional training and mentoring for new hires
- Adopt an exception to allow a retired employee to fill a position until a new employee is hired
- Adopt a "normal" retirement age (59 1/2 years old was suggested) to allow for pre-termination agreements and to prevent conflicts between the State Retirement System and any alternative retirement systems
- Adopt a different break in service for 9 month and 10 month employees
- Permanently exempt the UNC Phased Retirement Plan
- Define the break in service as 30 days
- Shorten the 6-month break in service
- Adopt less restrictive requirements for retirees who want to work part-time or who are subject to the earnings cap
- Clarify the law to allow retirees to work, during the break in service, for private companies that provide services to a State agency or school district when the employee receives no direct payment from the school district or the State agency