

## Questions/Clarifications for the Department of State Treasurer

Committee discussion relative to 6 month "Break in Service": IRS indicates there should be a break in service. Staff advised that State could set it for no shorter than 6 months. Retirement System indicates - break in service with no pre-existing condition to return to work [is policy/practice].

Questions:

**1. How does the State of North Carolina define "Break in Service" for all purposes related to benefits including retirement?**

We do not know all the ways in which "Break in Service" is defined for any type of benefit, but for retirement benefits in the Teachers' and State Employees' Retirement System, the definition is essentially contained in the definition of "Retirement" in G.S. 135-1:

"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 six months immediately following the effective date of retirement. For purposes of this subdivision, service as a member of a school board shall not be considered service.

## 2. What is IRS policy regarding re-employment after retirement?

IRS policy is based on the Internal Revenue Code (IRC), which is a set of laws passed by Congress, and various regulations and rulings issued by the IRS or the U.S. Department of the Treasury (the parent organization of the IRS) clarifying the application of the IRC. The key references on which the IRS relies in its interpretation of re-employment appear to be:

- Section 1.401-1(b)(1)(i) of the Income Tax Regulations which specifies that a pension should be for the payment of benefits after retirement.
- Revenue Rulings 56-693, 60-323, and 74-254 which forbid employees from receiving pension funds prior to normal retirement.
- IRC Section 401(a)(36) which lifted the prohibition on pension plans providing in-service distributions after age 62, effective 12/31/2006.

Distributions are permitted to a former employee who has terminated his or her employment. The IRS has indicated that the definition of a termination (break in service) would depend on the facts and circumstances of the case, but that there would probably need to 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." (IRS response dated 1/25/05 to NCRSD request for private letter ruling on re-employment issue).

### **3. What factors contributed to NC's adoption of the 6-month period for re-employment?**

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.

#### 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.

A major change to the Return to Work policy took effect on January 1, 1999. It is an 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 6-month period was adopted in the 2005 Appropriations Act (S.L. 2005-276). The section of the act in which the change is made is titled "CONFORM RETIREE RETURN TO TEACHING BENEFIT TO IRS GUIDELINES/CLARIFY DEFINITION OF RETIREMENT".

The Fiscal Research staff and legislators who created this legislation are probably better sources to provide the detailed factors involved in writing and passing the bill in this form.

#### **4. How do other states restrict re-employment?**

We have not been able to find a current, comprehensive survey of re-employment practices across states. However, we are able to make some observations based on our knowledge of other states:

- Practice varies significantly from one state to another.
- We do not know of any state that allows immediate re-employment of retirees with no restrictions.
- Most states require some break in service, although the period varies from around one month to around one year. Most states also forbid pre-existing arrangements to return to work.
- Many states require retirees to return in a part-time position and place a limit on earnings.

- Some states permit retirees to return to work only for a different agency than the one for which they originally worked as an active employee.
- Some states require documentation and high-level approval of an official skill shortage in order to rehire a retiree.
- A small number of states do allow phased retirement and/or in-service distributions after a certain age, but that age is usually at least 60 and sometimes as late as 65.
- Policies are influenced by a range of factors including federal regulations, financial costs, and workforce needs.

**5. Any change in state policy that could affect the eventual duration of the period of retirement will have and actuarial effect on the retirement fund. What would be the potential effect, if any, if employees were allowed to return to state service after a shorter break in service than the existing six months?**

To calculate employer contributions, 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.
- The system's actuary has estimated that 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 or reducing restrictions on re-employment of retirees will accelerate the retirement rate of eligible employees. This could negatively impact the State Pension Fund because an increased number of employees will retire and draw pensions for a longer period of time than was projected and thus funded.

Two bills were introduced during the 2007 Session of the General Assembly that are related to, but not the same as, the proposal in this question.

House Bill 34 would eliminate the postretirement earnings restriction for TSERS retirees, but would not change the 6-month requirement. The estimated increase in annual contributions due to HB 34 was \$88.5 million.

House Bill 237 would allow commencement of retirement benefits at the earlier of age 60 with 25 years of service or age 65 with 5 years of service, without a break in service and with no limit on earnings. For some retirees, it would place a greater restriction on postretirement earnings. Finally, it would reduce the required break in service to a little over one month for some full-time, year-round employees. The actuary estimated that the increase in annual contributions due to HB 237 was \$25.2 million.