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2010

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Workplace Flexibility 2010, Georgetown University Law Center

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Phased Retirement Benefits and Final Full Retirement Calculations: Open Issues

This document briefly describes two issues relating to the final, full retirement benefit for individuals who receive a phased retirement distribution from a defined benefit plan: 1) whether and how any phased retirement distribution would offset the final full retirement benefit, and 2) the form of the payment of the final, full retirement benefit.

Benefit Offset

Most pension plans are designed to provide a benefit upon full retirement or severance from employment. This merely requires a one-time calculation of the benefit. In general, the calculation is based on the employee's service and compensation up to the annuity starting date (subject to cost of living increases, if part of the plan design).

Because phased retirement programs did not exist when the majority of pension plans were designed, the question of whether, and to what extent, phased retirement distributions should offset final, full retirement benefits has not been addressed. However, now that employers are considering providing phased retirement benefit programs within defined benefit plans, employers and the IRS must grapple with whether an employee's final full retirement benefit should be offset by the phased retirement distributions.¹

In general, the phased retirement distribution constitutes a portion of the employee's accrued benefit at the time the employee entered a phased retirement program.² If the phased retirement distributions were to be offset, the total amount of benefits received during the phased retirement period would be actuarially adjusted to match the final form of benefit payment and expected length of such payment.

Generally, there are three options for calculating the final, full retirement benefit for an employee who has received phased retirement distributions:

- 1) No offset to the final, full retirement benefit for amounts received during phased retirement.

¹ The concept of offsetting a final, full retirement benefit is not new. For example, under the Internal Revenue Code (Code), in an individual terminates employment, receives a distribution and does not repay the distribution upon reemployment, service relating to the prior distribution need not be taken into account in determining the final accrued benefit upon a subsequent termination. Code § 411(a)(7).

² For example, the IRS proposed regulations on phased retirement would permit a pro rata share of an employee's accrued benefit to be paid to an employee in a phased retirement program. The pro rata share would be based on the extent to which the employee had reduced hours under the program. Prop. Treas. Reg. §1.401(a)-3(d)(4).

2) An offset for any amounts received, including any early retirement subsidy.

3) An offset only for the accrued benefit, but not for any early retirement subsidy.

There are pros and cons to each approach, for both the employer and the employee. Under the first approach, the employee would, most likely, receive a windfall, because the employee would receive a larger distribution than had the employee not entered into a phased retirement program. Under the first approach, the employee would receive the amount of the phased retirement distribution *plus* a final, full retirement benefit based on all service to the date of retirement (which would have been the only benefit available had the employee not received a phased retirement distribution).

Under the second approach, the employee might actually be penalized for receiving a phased retirement distribution. Under this approach, an offset for all amounts received prior to full retirement – including the phased retirement distribution and the early retirement subsidy -- could result in the employee receiving less than the employee would have received had the employee not entered into a phased retirement program because the final benefit would not be offset by the addition of the early retirement subsidy.

The third approach appears to strike a balance with respect to fairness to both the employee and the plan. Under the third approach, only the portion of the actual accrued benefit received would offset the final full retirement benefit, and the employee would still receive his or her early retirement subsidy. The only downside may be that this could impose an additional calculation on the plan to separate out the early retirement subsidy amount received from the amount of the accrued benefit received.

In its proposed phased retirement regulations, it is unclear whether the Internal Revenue Service (IRS) adopted the second or the third approach. The proposed regulations provide that:

Upon full retirement following partial retirement under a phased retirement program, the employee's total accrued benefit under the plan (including the employee's accruals during the phased retirement period), . . . is offset by the portion of the employee's phased retirement accrued benefit that is being distributed as a phased retirement benefit at the time of full retirement.³

³ Although the preamble to the proposed phased retirement regulations does not directly address this, it appears that the IRS would not endorse offsetting the final retirement benefit by the early retirement subsidy. In the preamble, with respect to the final form of benefit, the IRS explained that the reason for allowing an individual either to continue his or her phased retirement

Prop. Treas. Reg. § 1.401(a)-3(d)(3).

It is unclear whether the phrase “the portion of the employee’s phased retirement accrued benefit that is being distributed as a phased retirement benefit at the time of full retirement” includes the portion of the distribution that is based on an early retirement subsidy. In its Notice of Proposed Rulemaking, the IRS requested the following comments:

The proposed regulations require an offset for the actuarial value of additional payments made before a reduction in phased retirement benefits. Should the regulations permit this offset to be calculated without regard to any early retirement subsidy, and, if so, how should a subsidy be quantified?⁴

One commentator noted that it would appear that under the IRS proposal, “the intent of this reduction is to reduce the total value of the benefit by the actuarial equivalent of the amount that was previously paid to a participant. Therefore, the reduction to the regular retirement benefit should include all amounts paid previously, including the early retirement subsidy. . . [We] believe[] that not including the early retirement benefit could create an incentive for plan participants to claim a larger work schedule reduction than actually intended in order to receive a larger total benefit.”⁵

Form of Benefit

When an individual fully retires under a defined benefit plan, the individual is given a choice prior to the individual’s annuity starting date regarding the form in which the individual would like to receive his or her final retirement benefit. For example, under current law, a married participant must be provided with a 50 percent joint and survivor benefit. However, depending on the terms of the plan, the participant, with the consent of his or her spouse, could elect a different form of benefit under the plan, such as a single life annuity or a lump sum payment. After the individual retires (and assuming that the individual does not return to work for the employer), the form of the benefit does not change nor is the individual allowed to elect a different form of benefit.

With respect to phased retirement programs within defined benefit plans, it is unclear how the form of the final, full retirement benefit should be decided. For example, the participant could be allowed retain one form of benefit for the

distribution upon full retirement or elect a new form was so that “the remainder of the employee’s benefit right is not adversely affected by participation in the phased retirement program.”

Distributions from a Pension Plan Under a Phased Retirement Program, Notice of Proposed Rulemaking, p. 11, available at

http://www.ustreas.gov/press/releases/reports/js2094_111004phasedretirementreg.pdf.

⁴ Id. at 16.

⁵ National Association of Federal Credit Unions, Comments on REG-114726-04.

portion of the benefit relating to the phased retirement distribution (which the individual began receiving as an annuitized benefit when the individual entered a phased retirement program), and elect a different form of benefit for the final full retirement portion. Alternatively, the participant could only be allowed to elect a form for the final full retirement benefit and the phased retirement benefit would be paid in that same form.

In the IRS proposed phased retirement regulations, the IRS stated that an individual who participates in a phased retirement program may either maintain the form of the phased retirement benefit at full retirement or elect a new optional form of benefit. Prop. Treas. Reg. §1.401(a)-3(d)(3)(iv). This could result in the plan having to make two different payments – namely one form of payment for the phased retirement benefit and one form of payment for the final, full retirement benefit. One commentator suggested that this rule should be changed and that for administrative simplification, the full retirement benefit should be calculated without regard to the form of the phased retirement benefit elected.⁶

⁶ See U.S. Chamber of Commerce, Proposed Regulations Section 1.401(a) – Phased Retirement IRS and REG-114726-04.