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Internal Revenue Service
CC:PA:LPD:PR (REG-114726-04)
Room 5203
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RE: Comments on Phased Retirement Proposed Regulations

Dear Madam or Sir:

This letter is to offer comments on the Proposed Regulations on Phased Retirement (REG-114726-04), particularly from the perspective of governmental plans. Ice Miller represents a number of these plans, but we are not submitting these comments on behalf of any one particular plan.

Preliminary Comments

Prior to providing those comments, we wanted to extend our appreciation to the Service for addressing an issue that has received, and continues to receive, considerable attention by public policymakers at the state and local government level. Currently, the Internal Revenue Code ("Code") and accompanying Treasury Regulations provide that pension plans must be designed to provide definitely determinable benefits after retirement. Treas. Regs. §§ 1.401(a)-1(b) and 1.410-1(b)(1)(i). Therefore, public funds often struggle with a way to demonstrate compliance with this fundamental requirement while addressing state legislative proposals to allow employees to receive pension benefits while continuing or returning to work. Couple these issues with the public plan's funding concerns, the uncertainty of the baby boomers' eventual retirement patterns, and the increasing cost of retiree medical care, and governmental employers and plans have a very challenging environment.

In the past, except for the university arena, the debate on this issue has generally occurred with the assumption that the answer would lie in one extreme or the other – either individuals would be allowed to receive 100% of their retirement benefits while reemployed or they would

not be. (Variations did occur in some public plans which allowed return to work with continued retirement benefits, so long as the retiree did not earn over a certain amount or work more than a specified amount.) These Proposed Regulations provide another option for addressing the sometimes competing pressures of the employer's need to retire experienced workers and the employee's desire to receive significant pension benefits accrued after years of service.

The Proposed Regulations are helpful in that they clarify a number of issues that public plans face. For example, the Proposed Regulations clarify that a pension plan may be designed to pay benefits at attainment of "normal retirement age," so long as that age is not set artificially low (earlier than a reasonably representative age for a typical retirement age for the affected workforce). The preamble also provides a helpful overview of in-service distribution restrictions for other types of retirement plans.

Specific Comments

- 1. We request that the Service amend Proposed Treasury Regulation § 1.401(a)-3(c)(2), which limits a bona fide retirement program to employees who have attained age 59 ½. We would request that this age limit be removed for qualified governmental plans that are not 401(k) plans.**

It is our understanding that the rationale for this limit is that the Service did not want to encourage employees to take a phased retirement if that would lead to the imposition of the premature retirement penalty under Code Section 72(t). However, we believe that there is another way of analyzing this issue that would permit the deletion of the 59 ½ requirement for qualified plans that are not 401(k) plans. For purposes of phased retirement, the Service is treated an employee as split into two employees – the employee who is retiring and the employee who continues at work. This is referred to by the Service as "dual status." With respect to the employee who is retiring, the employee is allowed to take a distribution, other than a lump sum.

Code Section 72(t) imposes an additional ten percent (10%) premature distribution tax on distributions that are paid to members prior to the date the member attains age fifty-nine and one half (59½), unless another exception applies. The premature distribution tax does not apply to:

- distributions made after the date the member attains 59½;
- distributions made after the member's death;
- distributions attributable to the member's disability;
- substantially equal periodic payments payable over the life (or life expectancy) of the member or the joint life (or joint life expectancy) of the member and member's designated beneficiary;
- distributions made to a member who separates from service after attainment of age 55;

- distributions used by the member to pay significant medical expenses (not to exceed allowable amount of deduction under Code Section 213);
- distributions to an alternate payee pursuant to a qualified domestic relations order; and
- distributions made on account of a levy under Code § 6331 on the qualified retirement plan.

With regard to the person who has retired for purposes of phased retirement, we would request that all of these exceptions be applicable if the facts warrant. We believe the Service's "dual status" concept supports the approach we are suggesting. For example, if the employee commences a lifetime payment of 50% of their normal retirement benefit, we think that should be treated as substantially equal, even though increased work could reduce the percentage in later years.

As a policy matter, many governmental plans have normal retirement ages that are lower than 59 ½, with early retirement benefits preceding those early retirement ages. Public safety is an example of this where a normal retirement age of 55 or lower is not uncommon. Governmental employers may wish to make this phased retirement available to public safety officers prior to age 55 in order to keep experienced employees on the job. The Service has already recognized the need for flexibility with regard to retirement ages for governmental entities and public safety, specifically in Treas. Reg. § 1.457-4(c)(3)(v). That regulation sets a floor for normal retirement ages for qualified police or firefighters at age 40. We would suggest that Treas. Reg. § 1.457-4(c)(3)(v) provides a good model for the Service to follow in the final Phased Retirement Regulations.

2. We request that the Service "codify" the holding in PLR 200420030 regarding the definition of normal retirement age in the Proposed Regulations.

As we noted above, one of the very helpful parts of the Proposed Regulations is the Service's statement regarding in-service distributions at normal retirement age. In PLR 200420030, the Service recognized that a governmental system that had more than one combination of age and service for an unreduced benefit could permit in-service distributions at age 60 with 5 years of service. Public retirement systems often offer a "menu" of eligibility requirements for retirement with full benefits. To have that point clarified would be of great assistance to them as they attempt to implement the Phased Retirement regulations when finalized.

3. We request that the Service permit employers to establish "proxies" for the hours test established by the Proposed Regulations.

One of the areas where the Service requested comments was with respect to the hours test:

Should eligibility to participate in a phased retirement program be extended to employees that reduce their workload using a standard, other than counting hours, to identify the reduction, and, if so, are there administrable methods for measuring the reduction?


We believe that the answer to this question should be "yes." As noted in the Proposed Regulations for 403(b) Plans, a plan may use a different measure of work (other than hours of service) if appropriate under the facts and circumstances. Prop. Treas. Reg. § 1.403(b)-4(e)(6). We believe that such an approach would also be warranted for Phased Retirement.

Concluding Remarks

If you believe it would be helpful, we would be happy to elaborate upon any of our comments or to provide additional information. We appreciate the opportunity to provide these comments.

Very truly yours,

ICE MILLER


Mary Beth Braitman


Terry A.M. Mumford (USC)

Enclosures