ISSUES FOR IMPLEMENTING PHASED RETIREMENT IN DEFINED BENEFIT PLANS

Jonathan Barry Forman* and Patricia L. Scahill†

ABSTRACT

U.S. society is aging. The nature of work has changed from work that requires physical strength to work based on knowledge. As a result, workers are beginning to phase into retirement rather than going directly from full-time work to full retirement. From a retirement income perspective, many final-average-pay defined benefit plans have features that make phased retirement difficult at best and detrimental at worst. U.S. pension law and regulations present barriers to phased retirement if the phased retiree wants to receive a portion of available pension benefits during phased retirement.

This paper examines private sector options to encourage phased retirement and to eliminate the disincentives that currently affect defined benefit plans. It offers alternative calculations of final average pay that do not penalize the part-time worker. It also demonstrates that the plan’s early retirement reduction and late retirement increase can be set to maintain actuarial equity throughout phased retirement. The paper presents benefit calculations with equal actuarial values for various payout patterns.

The paper discusses the coordination between phased retirement and subsidized early retirement. Finally, the paper notes some of the changes in ERISA that will be needed to facilitate phased retirement in defined benefit plans, especially for participants who want to receive pension distributions while working part time.

INTRODUCTION

As America ages, the workforce will need to change. The U.S. Bureau of the Census projects the number of people between ages 55 and 64 will grow 73.5% from 2000 to 2020, going from 24,276,000 in 2000 to 42,107,000 in 2020. At the same time, the population ages 25 to 54 is projected to remain level. From 1995 to 2002, employment rates remained level for men ages 55 to 61 and rose for women ages 55 to 61 as well as both men and women ages 62 to 64. However, labor force participation rates are much lower for both men and women ages 55 to 64 than for those ages 25 to 54. If the current labor force participation rates continue, the pool of available workers will decline as the population ages. Consequently, employers will need to find ways to retain their productive older workers.

Factors influencing the employment rate among people age 55 and older include economic conditions, Social Security benefits, and the prev...
alence and design of private pensions.\textsuperscript{6} Since the repeal of mandatory retirement,\textsuperscript{7} so-called “phased” or gradual retirement has started to replace the traditional “cliff” retirement pattern that had older workers leaving the workforce suddenly and never coming back. Many older Americans are staying in or reentering the workforce, especially in part-time and contingent work situations.\textsuperscript{8} According to a recent survey by Watson Wyatt, 16\% of the companies they surveyed now offer phased retirement programs.\textsuperscript{9} Also, according to one estimate, roughly one-third of older workers leave their long-held career jobs and begin new jobs that serve as a bridge to full retirement.\textsuperscript{10} Another Watson Wyatt survey found phased retirement more prevalent at firms in which workers have an average age of 45 or higher.\textsuperscript{11}

Clearly, both employers and employees are interested in phased retirement, but unfortunately, the U.S. pension system was not designed with an eye toward phased retirement. Many companies face serious legal impediments to establishing an effective phased retirement program, and Congress and administrative agencies are aware of at least some of these obstacles. In 2000 one of the working groups of the ERISA Advisory Council focused on phased retirement,\textsuperscript{12} and Representative Earl Pomeroy (D-ND) and Senator Charles Grassley (R-IA) introduced legislation that would change ERISA to permit employers to provide in-service distributions once an employee reaches age 59 \(\frac{1}{2}\) or 30 years of service.\textsuperscript{13}

**WHAT IS PHASED RETIREMENT?**

The definition of retirement is not simple. It is not just the time when an employee stops working and begins receiving retirement benefits. It has become a more complex activity. People work while receiving retirement benefits. Long-term employees “retire” from one career and go on to another. Some choose to work less—phasing out of their full-time jobs. As discussed in this paper, phased retirement refers to the situation in which a person works a reduced schedule on the career job before full retirement from that job. This paper does not discuss other arrangements such as bridge jobs.\textsuperscript{14}

**Why Is Phased Retirement Important to U.S. Retirement Policy?**

Phased retirement is not a new phenomenon. It is expected to increase in importance for the economy as the large cohort of baby boomers begins to reach retirement age. The baby boom generally is defined as those born from 1946 through 1964. The oldest of the baby boomers have already reached age 55—a common age for early retirement eligibility in defined benefit plans. The boomers will begin reaching age 65 in 2011. With increased longevity and more healthy years, many baby boomers will have an active life well beyond age 65.

EBRI's 2001 Retirement Confidence Survey found that 26\% of current retirees say they have worked either full time or part time since they

\textsuperscript{6} Ibid.

\textsuperscript{7} Mandatory retirement is still allowed for certain highly compensated employees.


\textsuperscript{9} Watson Wyatt, Demographics & Destiny: Winning the War for Talent (1999).


\textsuperscript{11} Watson Wyatt, Phased Retirement—Reshaping the End of Work (1999).


\textsuperscript{13} The Phased Retirement and Liberalization Act (S. 2853/H.R. 4837) (2000).

\textsuperscript{14} Some employees leave their career job and work, usually part-time, for another employer. This job is used to “bridge” the transition from full-time work to full retirement and is referred to as a bridge job. Bridge jobs are often very different from the person’s career job, perhaps requiring different skills in a different industry. Current impediments to in-service distributions from defined benefit plans during phased retirement force many workers to use a bridge job as the phased retirement vehicle rather than a reduced work schedule of the career job.
retired. Not all employees will have other sources of income, such as investment income, to supplement their earned income during phased retirement, so they may need to access at least a portion of their pension as they ease into full retirement. The current U.S. pension system does not facilitate phased retirement, especially for defined benefit plan participants who want to begin phased retirement before the normal retirement age and receive benefits from the pension plan while still working. The conflict between part-time work and phased retirement is an example of unintended consequences in U.S. pension law. Legislative and regulatory changes that will allow employers and workers to structure in-service access to retirement benefits will be necessary if phased retirement is to become an attractive alternative to a significant segment of baby boomers.

**ACTUARIAL EQUITY IN PHASED RETIREMENT PAYOUTS**

This discussion of actuarial equity begins with the premise that phased retirement should be beneficial to both the employer and the employee. The employer can then negotiate a different, or perhaps similar, phased retirement pattern with various employees. Each employee enjoys freedom to design his or her transition from full-time work to full retirement. The employer enjoys the productivity and talent of the employee during this transition time.

Given the premise that phased retirement is beneficial to both the employer and the employee, the financial impact of whether the employee decides to supplement his or her phased retirement income with pension plan distributions should be actuarially neutral. The tables in this paper, as described below, demonstrate one way of achieving actuarial neutrality in phased retirement payouts. The key to this distribution neutrality is for the plan to make a full actuarial reduction for early retirement distributions as well as a full actuarial increase for continued employment after normal retirement.

**ACTUARIAL EQUITY IN PHASED RETIREMENT BENEFIT CALCULATIONS USING FINAL AVERAGE PAY**

**Traditional Final Five Years**

A traditional final-average-pay plan that averages, for example, the final five compensation amounts for determining benefits penalizes the phased retiree for continuing to work since part-time pay during phased retirement would be used in determining final average pay. The result is final average pay that decreases from year to year as a year of full-time pay is dropped from the final five years and a year of part-time pay is added in its place. Once the entire final average is based on part-time pay during phased retirement, the average will begin to increase as a result of salary increases in the rate of pay as a result of inflation, productivity, merit, and/or promotional increases. However, that average will likely be much smaller than the average just before phased retirement.

The definition of final average pay has a significant impact on the effect of phased retirement on the retirement benefits payable from a final average pay plan. Table 1 shows three possible definitions of final average pay that do not result in decreasing final average pay as described above. The table uses a participant who is working 50% of a full-time schedule during phased retirement that begins at age 60. The participant receives a 4% annual salary increase each year, including during phased retirement.

**Annualize Pay during Phased Retirement**

One alternative (Alternative 1 in Table 1) is to annualize pay during phased retirement years.

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15 Employee Benefit Research Institute, EBRI 2001 Retirement Surveys: Retirement Confidence Survey (RCS), Minority RCS, and Small Employer Retirement Survey (SERS), EBRI Issue Brief No. 224 (June 2001).

16 Current U.S. pension law was written without considering the trend toward phased retirement.

17 Actuarial neutrality, as used in this paper, is the situation where the timing and pattern of benefit payments during phased retirement have no impact on the employer or the pension plan because the actuarial value of the payouts is unchanged.

18 Actuarial assumptions must also be consistent to achieve this actuarial equity. If a defined benefit plan pays lump sums to phased retirees, this actuarial equity may not be possible because of mandated actuarial assumptions for lump sum calculations.
This approach is similar to the approach used by plans in industries such as health care where it is common for employees to work less than a full-time schedule. A participant working part time while phasing into retirement would receive a partial year of service. This approach avoids giving a disproportionate benefit accrual during phased retirement years by using a full year of benefit accrual service and pay annualized as if the participant received a full year of pay even though the participant is working part time and phasing into retirement. Alternative 1 has been used in the tables that compare various payout patterns shown later in the paper.

Use a Partial Year in the Divisor of Final Average Pay Fraction

Another alternative (Alternative 2) uses a partial year in the divisor of the final average pay fraction. For example, the first year the participant works 50% of a full-time schedule, the divisor would be 4.5 and the pay amounts would be the four years just before phased retirement and the first year of phased retirement (not annualized).

Table 1

<table>
<thead>
<tr>
<th>Age</th>
<th>Salary</th>
<th>Alternative 1</th>
<th>Alternative 2</th>
<th>Alternative 3</th>
</tr>
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<td>56</td>
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<td>58</td>
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<td>60</td>
<td>49,327</td>
<td>$ 87,838</td>
<td>$ 87,838</td>
<td>$87,838</td>
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<td>51,300</td>
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<td>90,540</td>
<td>87,838</td>
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<td>53,352</td>
<td>95,005</td>
<td>93,600</td>
<td>87,838</td>
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<td>55,486</td>
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<td>97,157</td>
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<td>57,705</td>
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<td>101,441</td>
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<tr>
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<td>60,013</td>
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<td>106,868</td>
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<td>—</td>
<td>130,021</td>
<td>130,021</td>
<td>87,838</td>
</tr>
</tbody>
</table>

Average Highest Five Compensation Amounts

Alternative 3 uses the average of the highest five consecutive compensation amounts throughout the entire service period. The disadvantage to this approach is that the participant does not benefit from any increases in the rate of pay during phased retirement. Since phased retirement should be structured to benefit both the employee and the employer, it seems unfair not to reflect pay increases in final average pay used to determine the benefit amount.

Clearly, Alternatives 1 and 2 produce very similar results (the only differences are at ages 61 through 64), but Alternative 3 does not change once the participant begins phased retirement.

Basic Assumptions Used in Payout Tables

The tables discussed in the following section illustrate benefit amounts under a simplified phased retirement scenario and a simple final average pay plan. Complete documentation of the formulas used in the tables is provided in the Appendix to allow the reader to develop a spreadsheet model to study other plan and phased retirement designs.

The benefit formula used is 1% of Final Average Pay times Credited Service, and the benefits are payable annually at the beginning of the year as a single life annuity. No service cap is used in the samples even though it is common for plans to use one. Benefits commencing before normal retirement are reduced actuarially from normal retirement age (age 65). Benefits commencing after normal retirement are increased actuarially for delayed retirement. These actuarial adjust-

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19 Some plans credit a full year of benefit accrual service for a year in which the participant earns 2,000 or more hours and credit a fraction of a year equal to hours worked divided by 2,000 for a year in which the participant works at least 1,000 hours but fewer than 2,000 hours. Many other service crediting options are available.

20 Full documentation of the formulas used to calculate the numbers in this table are shown in the Appendix.

21 It is not common for an employee to retire from the company at which he or she was hired at age 25. A participant’s retirement decision will depend on the expected retirement income from all sources. However, it is cumbersome to show retirement benefits from several employers and that impact on phased retirement benefits. We have, instead, chosen to use a career employee as our simplified example. We have not used a service cap in the benefit formula as a way of recognizing the trend toward multiple employers throughout a career.

22 As mentioned earlier, full actuarial reduction for early distribution
ments are based on 6.15% interest and GATT mortality.23

Participant 1 in the tables below does not phase into retirement. Participants 2, 3, 4, 5, and 6 begin phased retirement at age 60, working 50% of a full-time schedule. The plan’s normal retirement age is age 65. All participants are hired at age 25 and fully retire at age 70. Participants are assumed to earn $25,000 at age 25 and receive 4% annual pay increases until full retirement. Final average pay is the average of the last five compensation amounts.

**CLIFF AND PHASED RETIREMENT WITH NO IN-SERVICE DISTRIBUTIONS**

Participant 1 in Table 2 works full time until age 70 and then fully retires, receiving an annual retirement benefit of $70,763. By comparison, Participant 2 works the assumed phased retirement schedule described earlier, and the plan uses the pay and credited service definitions typically used today.24 The benefit payable to Participant 2 beginning at age 70 is only $35,383.

In contrast, Participant 3’s plan annualizes pay during phased retirement and credits a partial year of service equal to the portion of a full-time schedule worked during phased retirement.25 This participant receives $66,342 annually beginning at age 70 compared to $35,383 received by Participant 2—an 87% increase in benefit. The comparison of Participants 2 and 3 shows the importance of annualizing pay during phased retirement in order to avoid penalizing the participant for phasing into retirement with a significantly reduced retirement benefit.

<table>
<thead>
<tr>
<th>Participant 1</th>
<th>Participant 2</th>
<th>Participant 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final average pay at age 70</td>
<td>$130,021</td>
<td>$65,010</td>
</tr>
<tr>
<td>Normal retirement benefit</td>
<td>42,747</td>
<td>21,625</td>
</tr>
<tr>
<td>Benefit payable at age 70</td>
<td>70,763</td>
<td>35,383</td>
</tr>
</tbody>
</table>

**PHASED RETIREMENT WITH IN-SERVICE DISTRIBUTIONS**

Table 3 shows the impact on the ultimate benefit of various in-service distribution patterns. The section in this paper discussing the basic legal considerations with phased retirement talks about whether these options are allowed under current law. All examples in this section use the same final-average-pay definition as Participant 3 in the prior section and Alternative 1 above. In spite of the different payout pattern, the actuarial value at age 70 of the accumulated benefits received and the benefits to be received in the future is the same for sample Participants 4, 5, and 6 below as well as Participant 3.26

Participant 4 in Table 3 begins receiving 50% of the age 60 early retirement benefit ($9,842) at the beginning of phased retirement. Since only 50% of the early retirement benefit is being paid, the offset of benefits received against future benefit accruals is limited to 50% of the additional accruals.27 As a result, the participant continues earning additional accruals until full retirement at age 70.

Participant 5 begins receiving the full accrued benefit equal to $40,076 at normal retirement while continuing to work 50% of a full-time schedule until full retirement at age 70.28 Because the

23 GATT mortality was commonly used to determine lump sum distributions under §417(e) prior to 2003. It is a male-female blended version of the GAM-83 mortality tables.
24 The typical credited service definition is either elapsed time or one year credited for 1,000 hours worked. The typical pay definition used for Participant 2 is actual pay without annualizing pay during part-time work. Under this definition, pay decreases during phased retirement. The impact of this pay definition on final average pay was not illustrated earlier.
25 The final average pay for Participant 3 is Alternative 1 shown in Table 2.
26 See the section discussing actuarial equity in phased retirement payouts for more discussion of how these equal actuarial values were achieved.
27 This offset for partial benefit payments is not required under current law. As described elsewhere, current law does not facilitate payment of partial benefits. In addition, current law also makes no effort to achieve actuarial equity when a participant receives in-service distributions.
28 This alternative is allowed under current law.
full accrued benefit is payable during phased retirement, the offset for benefits received applies to the entire accrued benefit. As a result, the participant does not accrue any additional benefits from age 65 to age 70.

Participant 6 begins receiving 50% of the age 65 accrued benefit beginning at age 65. Since only 50% of the age 65 accrued benefit is payable before full retirement, the offset for benefits received before full retirement applies only to 50% of the additional benefit accruals.

**Comparison of Actuarial Value of Benefits at Age 70 for Various Payout Patterns**

As mentioned above, the actuarial value of benefits under the payout patterns for Participants 3, 4, 5, and 6 are equal at age 70 (see Table 4 below). The key to this equality is the full actuarial reduction for distributions beginning prior to normal retirement and the full actuarial increase for benefits beginning after normal retirement.

**Is Phased Retirement Good Public Policy?**

Workers currently have the option of easing into retirement without changing jobs. However, we discuss below the pitfalls inherent in the current legal framework. Is it good public policy to change the law to support phased retirement?

On the one hand, one could argue that providing workers with more opportunity to manage the end of their career is good public policy. Rather than forcing employees to change jobs in order to access their retirement benefits, employees would be able to continue their career job at a reduced schedule and receive a portion of their retirement benefits if the law is changed to make this option a realistic one.

If some of the current legal obstacles to a flexible phased retirement program were removed, phased retirement would have to be available on a nondiscriminatory basis. With widely available phased retirement, employers would be faced with the issue of whether a phased retirement program is retaining the highly skilled and effective workers or the ones who are no longer effective. Employers who offer early retirement incentive programs face the same type of problem. The solution to this problem does not lie in the particulars of the retirement program; instead it lies in effective workforce management.

Early access to retirement benefits may cause inadequate benefits upon full retirement. As shown above, the benefit payable upon full retirement becomes smaller as a larger portion of the benefit is received during phased retirement. Participant 3 receives a lifetime benefit of $66,342 upon full retirement, but this participant did not receive any benefits during phased retirement. In

<table>
<thead>
<tr>
<th>Participant</th>
<th>Accumulated Value at Age 70 of Benefits Received from Ages 60 to 69</th>
<th>Present Value at Age 70 of Future Lifetime Benefits</th>
<th>Actuarial Value of Past and Future Benefit Payments at Age 70</th>
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</thead>
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<td>1</td>
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<td>$680,300</td>
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<tr>
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<td>637,800</td>
</tr>
<tr>
<td>6</td>
<td>126,300</td>
<td>511,500</td>
<td>637,800</td>
</tr>
</tbody>
</table>

**Table 4**

Comparison of Actuarial Value of Benefits at Age 70

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29 As an alternative, one might want workers in phased retirement to continue to earn additional benefit accruals even beyond the date on which they draw full retirement benefits. For example, Participant 5 would see a small increase in the $40,076 benefit at age 66 and beyond to take into account additional accruals for work beyond age 65. Alternatively, a single larger adjustment might be made to the benefit to be paid once the worker fully retires at age 70.

30 Actuarial values calculated using 6.15% interest and GATT mortality (blended GAM-83).
contrast, Participant 5 receives the full accrued benefit of $40,076 beginning at age 65 during phased retirement, and this benefit amount does not change upon full retirement. Although the actuarial value of both payout patterns is the same, upon full retirement the participant no longer has earnings to supplement the retirement benefit. As a result, the distribution upon full retirement may be inadequate.

Many traditional defined benefit plans provide subsidized benefits to those who elect to commence benefits before normal retirement. Are these subsidized early retirement benefits consistent with phased retirement? Subsidized early retirement benefits provide an incentive to participants to retire before normal retirement. If plans are not able to pay partial benefits during phased retirement, as is the case currently, participants must forfeit the early retirement subsidy in order to ease into retirement through phased retirement. On the other hand, participants who do not want to give up the early retirement subsidy but still want to work are forced to retire from their career job and take a bridge job.

If it is good public policy to allow workers to delay retirement by facilitating phased retirement, does it make good public policy for pension plans to encourage early retirement at the same time? These policies seem contradictory. Making pension plans age-neutral by requiring a full actuarial reduction is one way to eliminate this contradiction. Requiring an actuarial increase for delayed retirement and not allowing suspension of benefits is the other part of ensuring actuarial neutrality. If a full actuarial adjustment is applied to early and late distributions, the present value of the benefits paid from the plan does not change regardless of the payout pattern selected by the participant.

The Phased Retirement Liberalization Act, introduced by Congressman Earl Pomeroy and Senator Charles Grassley in 2000, would have allowed in-service distributions at the earliest of age 59½, 30 years of service, or normal retirement age. The bill would have eliminated the 10% additional income tax on premature distributions for anyone with 30 years of service who is receiving in-service distributions before age 59½. The bill did not address paying partial benefits upon phased retirement or the method of reducing benefits for early commencement or increasing them for delayed commencement.

**Basic Legal Considerations with Phased Retirement**

There are many legal considerations that impact a phased retirement program. The following discussion introduces some of the legal considerations, but a full discussion is beyond the scope of this paper.

**Paying Partial Benefits before Full Retirement**

Although there is nothing specific in ERISA that prohibits defined benefit plans from paying partial benefits, there are a number of obstacles that may make these benefits impractical. For example, an employee taking phased retirement might want to receive 50% of his accrued benefit while working 50% of a full-time work schedule. ERISA and the Internal Revenue Code and related regulations refer to commencement of benefits, calculation of accrued benefits, spousal consent, etc., as they apply to the full pension. The statute and

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31 A common early retirement reduction in a plan with age 65 as the normal retirement age reduces the benefit 20% at age 62, 33% at age 60, and 50% at age 55. An actuarial reduction using 6% interest and GAM 94 mortality would reduce the benefit 25%, 37%, and 58%, respectively. The common early retirement reduction provides benefits more valuable (with a lower reduction) than an actuarial reduction and is referred to as subsidized early retirement.

32 Pension plans are considered age-neutral if nothing in the plan favors or disadvantages employees on account of age. There are protections to prevent unfair age discrimination, but pension benefits before normal retirement seem to be excluded from that protection. As a result, the plan can provide subsidized early retirement benefits that are most valuable at the earliest retirement age and become less valuable as the participant nears normal retirement. An age-neutral benefit would have the same actuarial value regardless of the age at which the benefit begins. Requiring a full actuarial reduction would require plans to either increase the value of benefits at later ages or reduce the value at earlier ages. See, e.g., Jonathan Barry Forman, “How Federal Pension Laws Influence Work and Retirement Decisions,” 54(1) Tax Lawyer 143 (2000).


34 For more discussion of the legal issues, see Patricia L. Scahill and Jonathan Barry Forman, “Protecting Participants and Beneficiaries in a Phased Retirement World,” available at http://www.soarlibrary/monographs/retirement_systems/m-rs02-2/m-rs02-2_tableofcontents.html.
related regulations do not discuss paying some portion of the benefit beginning at one date and then paying the full benefit at a later date.

The challenge for sponsors designing a balanced phased retirement program is how to offset for partial annuity distributions. If the entire additional benefit accrual were offset by the annuity value of the benefits paid, it is likely that no further benefits would accrue after in-service distributions began. The only increase in the benefit ultimately paid out at age 70 over the benefit payable at age 60, for example, would be the elimination of the early retirement reduction that applies at age 60.

Alternatively, because only 50% of the age 60 accrued benefit is being paid out, the offset could apply only to half of the additional benefit accrual. As a result, the participant continues accruing at least 50% of what would have been accrued if no distributions had been received.35

**In-Service Distributions before Normal Retirement Age**

A defined benefit plan cannot make in-service distributions before the plan’s normal retirement age under current law.36 Many defined benefit plans use age 65 as the normal retirement age, so employees who want to begin phased retirement before the plan’s normal retirement age are not able to use pension benefits to supplement earned income during phased retirement.

**Disclosure Requirements**

Disclosure of information about the plan and its benefits is one of ERISA’s participant protections. Effective communication about the plan helps participants understand and take advantage of the benefits offered. It may be difficult for participants to understand the impact of phased retirement on their ultimate pension benefits.

**Nondiscrimination Protection**37

The mechanical nondiscrimination rules can create problems for employers who try to accommodate employees who want to phase into retirement. Under current law, a defined benefit plan cannot make in-service distributions before normal retirement age. If the employer considers lowering the normal retirement age to accommodate in-service distributions, the plan must be able to pass nondiscrimination tests using that earlier normal retirement age.38

If phased retirees are the only participants who can receive certain payout options, such as partial benefit distributions, the sponsor must be careful that the effective availability of those options does not discriminate in favor of highly compensated employees. The demographics of those actually taking phased retirement will determine whether these special payout options are discriminatory under current nondiscrimination rules.

**Spousal Consent**

Spousal consent is an effective protection only if the spouse understands the impact of waiving the QJSA.39 This communication challenge is not unique to phased retirement. If the participant works a reduced schedule during phased retirement, but he or she does not elect to receive any pension benefits before full retirement, spousal consent will not be affected by phased retirement.

If the participant elects to receive benefits during phased retirement, spousal consent would be required if the benefit were not payable in the form of a QJSA when phased retirement benefits begin. Upon full retirement, another spousal consent would be required for the additional benefit that will be payable.40 The requirement of multiple spousal consents may be confusing to the spouse, so the plan sponsor should try to ensure that the spouse understands that the initial consent applies only to the initial partial benefit.

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35 This alternative is used in the tables above, and it is one key to achieving actuarial equity in phased retirement distributions.

36 Treas. Reg. §1.401-1(b)(1)(i) states “[a] retirement plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of . . . benefits to his employees . . . after retirement.” In PLR 8137048, the IRS applied this regulation and concluded that an employee may not receive a distribution from a pension plan before normal retirement while still an active employee.

37 I.R.C. §401(a)(4).

38 Of course, there are many other problems for traditional average pay plans that use an early normal retirement age such as much higher plan costs unless the benefit formula is modified.

39 Qualified joint and survivor annuity.

40 Treas. Reg. §1.401(a)-20, Q-9.
CONCLUSION
Phased retirement provides employees with important options for managing the end of their working career. It provides employers with a way to retain valuable knowledge workers who no longer want to work full time. It is important for U.S. pension law and regulations to be modified to facilitate phased retirement, but those changes should include safeguards to protect workers and spouses as they make decisions that will have a lifetime financial impact.

APPENDIX 1
DETAILED FORMULAS USED IN BENEFIT CALCULATIONS WITH NO IN-SERVICE DISTRIBUTIONS41

Phased Retirement Assumptions
- Participant takes phased retirement and works 50% of a full-time schedule beginning at age 60 and fully retires at age 70
- No benefits are payable during phased retirement, and full benefits are received at full retirement

Salary and Final Average Pay for Participant 2
- Salary is $25,000 at age 25 accumulated to current age at 4% salary increase
- FAP is the average of the prior five years’ salary

Salary and Final Average Pay for Participant 3
- Salary is $25,000 at age 25 accumulated to current age at 4% salary increase
- Salary is annualized by dividing pay for the year by the percentage of a full-time schedule worked in the year. During phased retirement, since the participant works 50% of a full-time schedule, the salary is divided by 0.5.
- FAP is the average of the prior five years’ annualized salary

Credited Service
- Participant 2: A full year of service is credited for each phased retirement year
- Participant 3: A partial year of service equal to the portion of a full-time schedule worked during the year is credited during phased retirement

Adjusted Accrued Benefit
- The accrued benefit reduced actuarially for early retirement for ages before age 65 and increased actuarially for late retirement for ages over age 65

Accrued Benefit Payable
- The Adjusted Accrued Benefit for the current age, but not less than any prior accrued benefit payable

APPENDIX 2
DETAILED FORMULAS USED IN BENEFIT CALCULATIONS WITH IN-SERVICE DISTRIBUTIONS42

Phased Retirement Assumptions
- Participant takes phased retirement and works 50% of a full-time schedule beginning at age 60
- Participant fully retires at age 70

Salary and Final Average Pay
- Salary is $25,000 at age 25 accumulated to current age at 4% salary increase
- FAP is the average of the prior five years’ annualized salary, where annualized salary is the actual salary divided by portion of the year worked

Benefit Formula
- Benefit formula shown above using final average pay and credited service where credited service is the sum of all prior portions of year worked
- Partial years of service are credited during phased retirement

Adjusted Accrued Benefit
- The accrued benefit reduced actuarially for early retirement for ages before normal retirement age and increased actuarially for years after normal retirement age

41 For tables showing detailed calculations, see Scahill and Forman, “Protecting Participants and Beneficiaries” (note 1 above).

42 For tables showing detailed calculations, see ibid.
• Formula for early retirement reduction to age \( x \):
Benefit from Formula_{65} \times \frac{N_{65}}{N_x} but not less than any prior adjusted accrued benefit

• Formula for late retirement increase to age \( y \):
Benefit from Formula_{65} \times \frac{N_{65}}{N_y} but not less than the benefit from formula at age \( y \)

Cumulative Offset for Benefits Paid

• The adjustment reflects the annual benefit that could be purchased with the benefits that were received in prior years
• Prior benefit payments are actuarially increased to the current age
• This formula follows Example 3 of §1.411(b)-2
• PRBA = phased retirement beginning age

Accrued Benefit Payable after Adjustment for Benefits Paid

• Before PRBA, the prior year’s accrued benefit payable after adjustment for benefits paid plus the current year’s increase in accrued benefit after adjustment for benefits paid
• Beginning with the age at which benefits are first paid,
Accrued Benefit Payable_{PRBA} + Increase in
Accrued Benefit after Adjustment for Benefits Paid

Benefit Payout Assumptions: Participant 4

• 50% of the accrued benefit at initial phased retirement is payable during phased retirement
• Accrued benefit payable after adjustment for benefits paid at full retirement begins at that age

Benefit Payout Assumptions: Participant 5

• 100% of the accrued benefit is payable beginning at normal retirement
• Accrued benefit payable after adjustment for benefits paid at full retirement begins at that age

Benefit Payout Assumptions: Participant 6

• 50% of the accrued benefit is payable beginning at normal retirement
• Accrued benefit payable after adjustment for benefits paid at full retirement begins at that age

Discussions on this paper can be submitted until January 1, 2004. The authors reserve the right to reply to any discussion. Please see the Submission Guidelines for Authors on the inside back cover for instructions on the submission of discussions.