

## **Guidelines for Returning Teachers to the Classroom**

### **General Overview**

A number of years ago, the Virginia Retirement System (VRS) became aware that school systems were implementing early retirement incentive programs that allow a teacher to return to the classroom the year following retirement for a specific number of days, such as 20 to 25 days, as a substitute. VRS understood that the teacher was paid for the days actually worked. The teacher could decline on any given day to report to the classroom, but had to report at least the number of days in the contract in order to collect the incentive benefit. VRS did not raise questions about this arrangement because it did not appear to violate the Internal Revenue Service (IRS) laws prohibiting “in-service distributions,” i.e., distributions from a pension plan prior to a bona fide severance from service (discussed in more detail below). The teacher was not bound to any specific schedule and was not considered to hold a “near” full-time job in the following year. In addition, this arrangement represented a significant change in the job requirement, thus there was no reason to question a teacher’s intention to enter retirement.

What has evolved from those early programs is a new generation of early retirement programs that requires the teacher to commit to work in an almost full-time capacity, in some cases, over 170 days the following school year. Basically, they are excused from teacher work days and training. The teachers continue to have the same classroom, teach the same subject and in the same manner as any other teacher. The only significant difference is that they receive retirement benefits from VRS and are classified in a position not covered by VRS so that they do not earn future benefit accruals under the VRS plan. At the time they apply for retirement benefits from VRS, these teachers have committed to return to a “near” full-time job beginning at the same time they would have returned to work under the prior continuing contract. There is no significant change in the duties, responsibilities or time commitment. Thus, there is no evidence of the intent to sever their employment. Rather, the change is a mere change in status from full-time to less than full-time.

In order to address the “in-service distribution” rules, the VRS requires a 30-day break in service. That break must occur over a period of time that the employee normally would be working. For teachers, a break that occurs during the summer does not meet this definition. Without the required break, there is no evidence to support the bona fide severance from service necessary to prevent violation of the IRS “in-service distribution rule.” This is especially true if pre-existing arrangements exist for the teachers’ return.

This 30-day break in service requirement should not be confused with the bill passed by the 2001 General Assembly that allows teachers to return to the classroom in full-time positions that would otherwise be covered by VRS and eligible for additional benefit accruals. Teachers who take advantage of this arrangement will not experience a suspension of VRS benefit payments nor will they accrue additional benefits under VRS for the additional service. To participate in this arrangement, a teacher can return after a one-year break in service, provided the teacher did not participate in an early retirement incentive program (ERIP) and there was no

pre-existing arrangement with the school system to return. In addition, this return to the classroom without benefit suspension can occur only if the Department of Education (DOE) designated the geographical area or subject matter as a severe shortage area. These types of arrangements are different from those that require only a 30-day break in service over a period during which the teacher would otherwise have been working. In summary, the chart below illustrates the consequences of the benefit eligibility for various breaks in service.

	<b>Less than 30-day break in service</b>	<b>At least a 30-day break in service</b>	<b>One-year break in service with DOE shortage certification</b>
<b>Return less than full-time position</b>	No accrual of future benefits and no benefit payment	No accrual of future benefits and benefits may commence	No accrual of future benefits and <b>no</b> benefit payment suspension
<b>Return to full-time covered position</b>	Accrual of future benefits and no benefit payment	Accrual of future benefits and benefit suspension	<b>No</b> accrual of future benefits and <b>no</b> benefit suspension

The remainder of this document addresses the implications of the 30-day break requirement.

### **Implications for VRS**

VRS is intended to be a pension plan. A pension plan within the meaning of Internal Revenue Code (IRC) Section 401(a) 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.” *Treas. Reg. § 1.401-1(b)(1)(I)* (*emphasis added*). The word ‘primarily’ in the definition of a pension plan was intended to mean that such a plan is not precluded from meeting the applicable requirements for qualification merely because it provides benefits that are only incidental to the main purpose of the plan. However, a pension plan which permits participants to withdraw all or a part of the funds accumulated on their behalf prior to any severance of employment is inconsistent with the accepted concept of a pension plan which meets all of the requirements of Code Section 401(a). *Treas. Reg. § 1.401-1(b)(1)(i)* (*emphasis added*).

The IRS, through regulations, construes the reference to “after retirement” as a reference to severance of employment. As a result, a bona fide severance from service needs to occur in

order for the pension plan such as VRS to commence paying retirement benefits. The IRS has not given guidance, but simply says that whether there has been a bona fide severance from service depends on the facts and circumstances. To date, that is all the guidance that is available from IRS. Under facts and circumstances guidance, there are no specific time periods for the required separation or break. It is more about intention - and the period of separation is evidence of intention.

Because VRS is not in a position to review all facts and circumstances surrounding the intentions of employees when they submit a retirement application, VRS has tried to fashion guidance that may serve as evidence of intent. The current VRS guidance requires a 30-day break in service over a period during which the employee would otherwise be working. Absent the required break, the VRS does not view the employee's change of status to be a retirement. This guidance first applied for 12-month, non-school employees who might have arranged to return to non-covered positions. The VRS could have picked a longer, more conservative period, but VRS tried to strike a balance between its need to protect the tax qualification of the plan and the needs of employers.

### **Implications for Teachers**

Teachers who receive a distribution from a retirement plan, such as VRS, before a bona fide severance from service is established may face direct tax consequences. Internal Revenue Code (IRC) Section 72(t) imposes a 10 percent penalty on taxable distributions from retirement plans received before the taxpayer reaches age 59-1/2. The exception that typically applies for early retirees is the exception for payments made to an employee after separation from service after age 55. If the IRS determines the teacher did not meet the bona fide severance from service requirement, all taxable retirement payments made to the teacher before reaching age 59-1/2 would be subject to the 10 percent tax penalty.

In addition to this potential penalty, teachers who work in one of these "near" full-time positions, but who are not reported to VRS as a covered member, do not receive additional service credit toward retirement. The retirement benefit for these teachers is frozen at an early age, rising only with cost of living adjustments. In some cases, these teachers receive retirement benefits that were subject to actuarial reductions that significantly reduce their retirement benefits. The retirement benefit, starting at an early age, plus the lump sum payment from the school system's early retirement program is all the teacher will receive in retirement benefits for the rest of his or her life.

Although VRS is not in a position to know the type of financial counseling teachers receive, it is a great concern. The counseling needs to focus on the true long-term effects of the

teacher's decision to trade future accruals in the defined benefit plan for a defined contribution payment that, on an actuarial basis, is less valuable than an additional year of service credit under VRS.

### **Implications for School Systems**

The 2003 General Assembly enacted Section 51.1-124.10 of the Code of Virginia to allow VRS to pass to the employer all financial penalties and costs imposed on VRS as a result of the employer not complying with federal and state laws and regulations. If any school system's actions subject the entire VRS fund to additional legal and compliance costs, those costs can be collected from the school system. Thus, any school systems' actions that have consequences to VRS also have direct financial consequences to the school system.

The financial implications for the school systems also include rising contribution rates to fund the benefits. The VRS contribution rates are based on certain assumptions, one being that the employer has until employees reach normal retirement age to fund the benefits that will be due at normal retirement age. As more and more teachers retire early with reduced or unreduced benefits, the funding rates will need to be adjusted to assume a shorter period of time over which to fund the teachers' benefits. That will result in continuing and escalating rate increases.

It appears that the early retirement programs established by school systems are intended to be IRC 401(a) tax qualified plans. School systems are permitted to establish these types of supplemental plans pursuant to Chapter 8 of Title 51.1 of the Code of Virginia.

The decision to sponsor such a plan should not be taken lightly. There are ongoing requirements associated with these plans. The IRS rules change periodically and the plans must be updated to remain in compliance with those rules on a timely basis. The sponsor is responsible for operating the plan in accordance with all the rules on an ongoing basis.

As described in Section 51.1-803 of the Code of Virginia, the sponsor of these plans has a fiduciary responsibility to the plan participants to see that the funds are invested "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with the same aims. Such investments shall be diversified so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so." VRS interprets this duty as requiring the undertaking of significant due diligence prior to selecting an investment provider and ongoing monitoring and review of the performance of the investments to make sure that the plan assets are invested prudently and most appropriately. This includes comparisons of rates of return and the applicable fees that might reduce the amount ultimately available for participants under the plan. This effort is not a one-time exercise but an ongoing process of managing and monitoring the assets in the best interest of the plan participants.

Chapter 10 of Title 51.1 of the Code of Virginia also imposes certain reporting and disclosure requirements applicable to these types of plans. While these are not onerous, they are an ongoing responsibility. In addition, in selecting the investments for their plan, each school system needs to be mindful of the requirements of the Investment of Public Funds Act (Virginia Code §2.2-4500 et seq.) or be able to identify a clear exemption.

## **Conclusion**

Over the past several years, VRS has tried to publicize its guidance relating to the 30-day break in service and the need for that break to be over a period during which the employee would not otherwise be working. A number of school systems have been working to change their programs to meet VRS guidelines and their efforts are very much appreciated. We believe however, that there are other school systems that have not yet begun to reevaluate their programs in light of VRS guidance.

In order to encourage school systems to take a closer look at their arrangements in light of the bona fide severance from service requirement and to protect the tax qualification of the retirement plan, VRS will begin to require additional certifications. Effective with January 1, 2006 retirements the employer and the member will be asked to certify that the member will not be reemployed until the severance from service period is satisfied. If the member is expected to return, the employer will be required to provide the anticipated return date. If the anticipated return date does not incorporate the appropriate 30-day break in service, the retirement application will be denied. The member will not be eligible to receive retirement benefits until a bona fide severance from service has occurred.

VRS will take no action with respect to retirees currently participating in a school system's early retirement program. However, any teacher employed for the 2006 school year needs to be in compliance.

Questions regarding this issue may be directed as follows:

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