

MEMORANDUM

October 23, 2019

TO: North Carolina Retirement Systems

FROM: David N. Levine
Kimberly M. Boberg

RE: Bona Fide Separation From Service

This memorandum examines a member's right to a distribution from retirement plans administered by the North Carolina Retirement Systems (the "Plans"). In particular, this memorandum addresses applicable separation from service requirements under the Internal Revenue Code (the "Code") and related agency guidance.

Summary of Analysis

Where a plan does not permit in-service distributions, there must be a bona fide separation from service in order to qualify for a distribution from the plan.¹ This rule comes from existing IRS guidance that concludes that a reduction in hours does not cause a termination or a bona fide separation from service for purposes of qualified retirement plan compliance. Further, the IRS guidance in this area specifically highlights the principle that no bona fide separation occurs where there is a prearrangement to terminate service for a period before resuming service with the employer.

Because of this guidance, we would expect that the IRS would treat such a distribution from the Plans as an impermissible in-service distribution in violation of the terms of the Plans and the qualification requirements of Code section 401(a). As such, we recommend that the Plans continue to apply this rule unless the IRS issues written authority specifically stating that an individual who has publicly affirmed an agreement to retire and return to work two-to-three months later has had a bona fide separation from service and may commence benefit payments from a plan qualified under Code section 401(a).

¹ We note that separate IRS guidance allowing for in-service distributions from defined benefit pension plans is generally limited to individuals who have either reached age 62, or, if earlier, normal retirement age, under the plan. However, we understand that the Plans do not permit in-service distributions at this time. If the North Carolina General Assembly were to amend the relevant Plan to permit in-service distributions at a permissible normal retirement age (as defined in proposed IRS guidance), it may be possible to allow this distribution.

Factual Background

The Plans are governmental defined benefit plans under Code section 414(d) and are qualified under Code section 401(a). In the fact pattern provided, an employee announced his retirement effective January 1, 2020. However, the employee and employer also agreed that the employee would return to employment in March and work through August. It is anticipated that the position upon the employee's return to work will be in a temporary or interim capacity.

Legal Background

Treas. Reg. section 1.401(a)-1(b)(1)(i) provides that “[i]n order for a pension plan to be a qualified plan under section 401(a), the plan must be established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement or attainment of normal retirement age”

Private Letter Ruling 201147038 (Apr. 20, 2010) (the “PLR”)² provides that a termination of employment must be bona fide (i.e., not a mere subterfuge in order to initiate an otherwise impermissible distribution where no substantial change in employment has occurred). Further, the PLR indicates that where there is an agreement between the employer and employee that an employee will return to service after their termination, a bona fide separation from service has not occurred. The PLR specifically provides that “if both the employer and employee know at the time of ‘retirement’ that the employee will, with reasonabl[e] certainty, continue to perform services for the employer, a termination of employment has not occurred upon ‘retirement’ and the employee has not legitimately retired.” Further, “employees who ‘retire’ on one day in order to qualify for a benefit under the Plan, with the explicit understanding between the employee and employer that they are not separating from service with the employer, are not legitimately retired.”

Treas. Reg. section 1.401(a)-1(b)(3) provides that “[f]or purposes of paragraph (b)(1)(i) of this section, retirement does not include a mere reduction in the number of hours that an employee works. Accordingly, benefits may not be distributed prior to normal retirement age solely due to a reduction in the number of hours that an employee works.”

Treas. Reg. section 1.409A-1(h)(1)(ii) (which is not applicable to Code section 401(a) qualified plans) provides that a termination occurs where an employee ceases providing services

² Code section 6110(k)(3) provides that a private letter ruling “may not be used or cited as precedent.” Thus, in any dispute between the Service and a taxpayer other than a taxpayer that receives a private letter ruling, the private letter ruling may not be cited as valid authority. However, although a PLR is not formal precedent that may be cited, it is authority that a taxpayer may consider to establish the tax consequences of a potential transaction or situation. See *Hanover Bank v. Comm’r*, 369 U.S. 672, 686-687 (1962) (“although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws.”); *Ogiony v. Comm’r*, 617 F.2d 14, 17 (2d Cir. 1980) (concurring opinion).

or permanently decreases provided services to no more than 20% of the average level of bona fide services performed over the preceding 36 month period.

In *Meredith v. Allsteel Inc.*, the Seventh Circuit gave retirement its ordinary meaning (i.e., to withdraw from one's position or occupation: to conclude one's working or professional career). 96 F.3d 1033 (1996).

Analysis

In order to retain their tax-advantaged status, the Plans must comply with the qualification requirements of Code section 401(a). Therefore, the requirements of the Code, regulations, and related guidance control, and the Plans must be interpreted in a manner consistent with these requirements.

Code section 401(a) requires that any separation from service must be bona fide in order for a member to be eligible to begin receiving their pension benefits from the Plans. In interpreting analogous IRS guidance, the PLR specifically notes that a distribution pursuant to a prearrangement between an employer and employee where an employee "retires" with the intent to return to service is impermissible, as such retirement was not a bona fide separation from service. Thus, as here, where there is a prearrangement indicating that the employee did not reasonably anticipate that he would no longer provide services to the employer, any distribution pursuant to such "retirement" would likely be considered an impermissible in-service distribution by the IRS.

We recognize that the conclusion in the PLR addresses a specific set of circumstances (i.e., termination and immediate rehire) that are slightly different than the two-to-three month rehire window in the current situation. However, we know that the IRS has audited governmental plans in the past with respect to the issue of the legitimacy of "separations from service". Were the IRS to conclude that the current case was not a valid bona fide separation from service, in a worst case scenario, a Plan could be exposed to the loss of its tax-qualified status and/or related financial penalties from the IRS, which could directly lead to the taxation of each year's employee contributions to the Plans that are currently exempt from federal income taxation. As such, we recommend that the Plans continue to apply this rule unless the IRS issues written authority specifically stating that an individual who has publicly affirmed an agreement to retire and return to work two-to-three months later has had a bona fide separation from service and may commence benefit payments from a plan qualified under Code section 401(a).

Given these significant potential risks, and as the intent of the parties may be difficult to demonstrate at times, it is common for governmental plan sponsors to establish minimum time periods during which employment must have ceased in order for any terminated and rehired employee to be treated as having had a bona fide termination of employment. However, where there is an understanding at the time of the member's retirement that he would return to employment (i.e., a prearrangement), the length of his separation is often treated as less relevant, and there is a greater risk that the IRS would find that no bona fide separation from service had occurred.

Further, of note, Treasury Regulations for nonqualified plans (*i.e.*, mainly private sector “executive” plans that are subject to rules very different than those applicable to the Plans) provide that a termination occurs where an employee ceases providing services or permanently decreases provided services to a defined level of bona fide services. However, a key reason to distinguish these Treasury Regulations is that no such language exists in the regulations governing 401(a) plans. In fact, the Treasury Regulations specifically provide that a reduction in hours is not a retirement. In addition, courts have given retirement its ordinary meaning with no a part-time exception. Thus, as we are not aware of any applicable guidance supporting the conclusion that an employee who works reduced hours would be considered to have a bona fide separation from service merely on account of such reduction, such that a member who continues to work in a temporary or interim status likely has not had a bona fide separation from service.