

Virginia Retirement System

2023 Fiscal Impact Statement

1. **Bill Number:** SB 1107 S1

House of Origin ☐ Introduced ☒ Substitute ☐ Engrossed
Second House ☐ In Committee ☐ Substitute ☐ Enrolled

2. **Patron Prior to Substitute:** Cosgrove

3. **Committee:** Finance and Appropriations

4. **Title:** Virginia Retirement System; law-enforcement officers; return to work.

5. **Summary:** Reduces from 12 to six months the required break in service before a retired law-enforcement officer may return to work full time and continue to receive their pension under the Virginia Retirement System. The substitute has a delayed effective date of January 1, 2024.

6. **Summary of Impacts**

Benefit(s) impacted: The substitute changes the currently required 12-month break in service to a six-month break in service for retired law enforcement officers who return to work full-time as a school security officer under the return-to-work exemption in § 51.1-155(B)(4).

Impact to unfunded liability (see Item 9 for details): This provision is not expected to have a large impact on changing retirement patterns of future retirees and therefore is not expected to meaningfully impact unfunded liabilities or contribution rates. Requiring employer contributions, as § 51.1-155(B)(4) does, will help to mitigate the impact related to filling VRS active covered positions with retirees for that plan's contribution rates, but will not help the plan they retired from if it was a different employer.

Impact to contribution rate(s) (see Item 9 for details): Because this legislation retains the requirement for employers to include the retirees' salary in computation of employer contributions as provided in § 51.1-155(B)(4), the provision is not expected to have as much of an impact on the unfunded liability or employer rates of the hiring employer. Employer contributions for these retirees help mitigate the impact on contribution rates. However, depending on the volume of members who retire earlier than expected, the plans from which they retire could see an increase in costs due to the increased liability associated with retiring earlier than expected in order to receive a pension, enhanced hazardous duty supplement, and active healthcare, as well as a full-time salary.

Specific Agency or Political Subdivisions Affected (see Item 10): VRS, school divisions that employ school security officers, and the political subdivisions that fund the school divisions.

VRS cost to implement (see Item 7 and Item 8 for details): Approximately \$29,800 in FY 2023, \$59,400 in FY 2024, and minimal ongoing costs. This legislation will create a different break in service requirement for retiree school security officers than for current teacher or bus driver critical shortage positions.

Employer cost to implement (see Item 7 and Item 8 for details): Minimal employer costs are anticipated for implementation.

Other VRS and employer impacts (see Item 7, Item 9, Item 11, and Item 12 for details): VRS will need to reach out to employers to communicate this change to the length of the required break in service applicable only to retiree school security officers.

GF budget impacts (see Item 8 for details): No immediate impact expected.

NGF budget impacts (see Item 8 for details): Approximately \$29,800 in FY 2023, \$59,400 in FY 2024, and minimal ongoing costs for VRS implementation.

7. **Budget Amendment Necessary:** Yes. Item 498. VRS will need a NGF appropriation of approximately \$29,800 in FY 2023 and \$59,400 in FY 2024 for implementation costs to cover the cost of programming and testing, as well as updating employee and employer communications, with minimal ongoing costs. This does not include the potential impact to future contribution rates or to the funded status of the state or local plans, which are discussed below.
8. **Fiscal Impact Estimates:** More detail on the fiscal impact is explained in Item 9 below.
9. **Fiscal Implications:** Item 498 of Chapter 2 of the 2022 Special Session I Acts of Assembly required VRS to review the current return to work (RTW) provisions governing its retirees. It has been published to the DLAS website at [RD856 \(Published 2022\) - Return to Work Provisions Governing Virginia Retirement System \(VRS\) Retirees – December 15, 2022](#).

Internal Revenue Service (IRS) guidance under Internal Revenue Code (IRC) § 410, as cited in Private Letter Ruling 201147038, suggests that a one-year period without performing service might be considered a safe harbor to establish severance from employment prior to a retiree returning to work for a plan employer. Failure to meet the facts and circumstances test for a bona fide break in service could jeopardize VRS' plan qualification status, thereby affecting all members and retirees. Qualification as a governmental plan allows pre-tax employee contributions and exemption from taxation on investment earnings, among other tax benefits. Historically, investment earnings fund approximately 2/3 of benefit costs.

Outside benefits counsel has confirmed that IRS guidance allows specifically for a bona fide break in service with no prearrangement for re-employment, and the IRS makes the determination of whether or not there is a break in service using a facts and circumstances test. The IRS has not established a definite safe harbor severance period but has indicated that 12 months may be a sufficient period of time.

VRS uses a one-year break in service for the bus driver and teacher critical shortage program. In 2001, when the teacher critical shortage program was first implemented, the Joint

Legislative Audit and Review Commission (JLARC) adopted a resolution concurring with VRS regarding the minimum one-year separation before a retiree could be rehired into a critical shortage position without loss of retirement benefits, consistent with the recommendation of the JLARC actuarial consultant. In addition, to be eligible for the critical shortage program the bus driver or teaching position must be identified by the Superintendent of Public Instruction pursuant to subdivision 4 of § 22.1-23, by the relevant division superintendent, pursuant to § 22.1-70.3, or by the relevant local school board, pursuant to subdivision 9 of § 22.1-79.

While VRS along with benefits counsel believes that a 12-month break in service before a retiree can return to work full time remains optimal to ensure compliance with IRS guidance and to minimize any potential negative impacts from changing retirement patterns, the report referenced above includes several options for consideration, including reducing the required break in service for critical shortage teachers and bus drivers and RSSOs to six months. If the break in service is reduced below six months, it becomes less clear that it would comply with IRS guidance. Changing the required break in service from two months, as the introduced legislation proposed, to six months in the substitute, is expected to mitigate impacts on retirement patterns.

As described in the Return to Work report referenced earlier, Exhibit 1 shows the number of retirees filling full-time school security officer positions with the current 12-month break in service.

Exhibit 1- Retirees Employed as Full-time School Security Officers

Year	Number of retirees filling school security officer positions
2020-2021	10
2021-2022	14
2022-2023*	19

Source: VRS data

*Through November 15, 2022.

The shorter the break in service, the more likely it is that active employees will take advantage of the opportunity to retire earlier than anticipated, which will potentially lead to larger shifts in retirement patterns.

Another factor that makes larger shifts in retirement patterns more likely with shorter breaks in service is the availability of active employee health insurance, which is typically subsidized by employers. Many employees delay retirement due to the high cost of pre-Medicare health insurance. If employees can retire, and, following a short break, receive a pension, the hazardous duty supplement, if eligible, earn a full-time salary and have access to employer-subsidized health insurance, there is little reason that retirement-eligible employees would not take this option. A six-month break in service, however, could still serve as protection for the plans from changes in retirement patterns where active employees retire

earlier than expected, while also documenting that the required severance of employment has occurred.

Employer contributions are crucial to mitigating the impacts of changing retirement patterns (earlier than anticipated retirements). This legislation maintains the required employer contributions. Requiring employer contributions, as § 51.1-155(B)(4) does, will help to mitigate the impact related to filling VRS active covered positions with retirees for that plan's contribution rates, but will not help the plan they retired from if it was a different employer.

As an example, the SPORS and VaLORS plans currently have approximately 410 members who have qualified for an unreduced retirement and are over age 60 but continue to work. Just assuming that these members would retire immediately would increase the liability of the SPORS plan by approximately \$5.8 million and the VaLORS plan by approximately \$7.0 million and would increase annual benefits payments by about 8.0% per year for SPORS and approximately 5.0% for VaLORS. There would also be impacts to the local plans that cover hazardous duty employees. The impacts to those plans would vary by employer based on who would elect to retire and return to work. The exhibit below provides the number of active hazardous duty who were eligible to retire as of June 30, 2022. The impacts discussed above are only associated with the 410 members over age 60 for SPORS and VaLORS, and this is the minimum impact expected. Members who have qualified for unreduced retirement are more likely to take advantage of return-to-work provisions, and as the exhibit shows below that represents about 7% of the current active hazardous duty population. Members from the second group identified below who have qualified for an unreduced retirement but who are under the age of 60 would also likely be incentivized to retire with the financial impacts of those members being even higher as they would be starting benefits even sooner and likely receiving their benefit with COLAs and possibly a hazardous duty supplement with COLAs for a longer period of time. We also expect that members in the third group with eligibility for reduced benefits could also elect to retire and continue working in certain circumstances in order to boost take home pay by collecting a retirement benefit and continuing to be paid a full-time salary.

Local Hazardous Duty Active Population June 30, 2022

	Employer Count	Percentage of Active Population
Total Actives	26,100	
Eligible for Full Unreduced Retirement Over Age 60	630	2.4%
Eligible for Full Unreduced Retirement Under Age 60	1,020	3.9%
Eligible for Reduced Retirement Under Age 60	2,550	9.8%
Total Eligible to Retire as of June 30, 2022	4,200	16.1%

SPORS Active Population June 30, 2022

	Employer Count	Percentage of Active Population
Total Actives	1,880	
Eligible for Full Unreduced Retirement Over Age 60	80	4.3%
Eligible for Full Unreduced Retirement Under Age 60	220	11.7%
Eligible for Reduced Retirement Under Age 60	140	7.4%
Total Eligible to Retire as of June 30, 2022	440	23.4%

ValORS Active Population June 30, 2022

	Employer Count	Percentage of Active Population
Total Actives	7,360	
Eligible for Full Unreduced Retirement Over Age 60	330	4.5%
Eligible for Full Unreduced Retirement Under Age 60	180	2.4%
Eligible for Reduced Retirement Under Age 60	900	12.2%
Total Eligible to Retire as of June 30, 2022	1,410	19.2%

10. Specific Agency or Political Subdivisions Affected: VRS, school divisions that employ school security officers, and the localities that fund them. .

11. Technical Amendment Necessary: No.

12. Other Comments:

Overview

The substitute reduces the bona fide break in service from twelve months to six months for a retired sworn law-enforcement officer employed in a local school division as a school security officer. The substitute has a delayed effective date of January 1, 2024. The substitute does not change the current requirement for employers to include these retirees' compensation in membership payroll subject to employer contributions under § 51.1-145 of the *Code of Virginia*.

Since the substitute does not make the same change to subdivision (B)(3), it creates a second, different break in service requirement for retiree school security officers.

Importance of Employer Contributions

Requiring employer contributions for retirees who return to work, as the substitute does, is critically important to mitigating potentially negative impacts to plan funded status and future contribution rates related to employees retiring earlier than anticipated. The shorter the required break in service the more likely employees are to retire earlier than anticipated, with the resulting change in retirement patterns. While not completely making up for the impact of changing retirement patterns, requiring employer contributions helps to make up for some of the potential negative actuarial consequences related to filling VRS active covered positions with retirees.

Eligibility for Active Employee Healthcare Coverage

In addition to the shorter break in service providing a strong incentive for active employees to retire and return to work, eligibility for active employee health insurance coverage, which is typically subsidized by employers, will likely encourage even more active employees to retire earlier than anticipated. One reason many employees delay retirement until age 65 is Medicare eligibility. If active employees can retire at age 50, receive a pension with cost-of-living adjustments and potentially a hazardous duty supplement and, following a six-month break, receive a full-time salary and employer-subsidized health insurance, it is more likely that retirement-eligible employees would pursue this option.

As an example, a law enforcement officer could retire with a reduced benefit as early as age 50 with at least five years of service credit. While Plan 2 and Hybrid Retirement Plan members have different age and service requirements, this legislation is most likely to apply to current Plan 1 members.

Significance of Required Break in Service

The 12-calendar-month break is intended to satisfy IRS guidance, to protect the VRS plan qualification, and to minimize the incentive for employees to retire earlier than they otherwise would. When an employee retires earlier than assumed, it adds costs to the plan since retirement benefits will be paid for a longer period of time than anticipated when contribution rates were set.

From a policy perspective and consistent with advice from benefits counsel, VRS remains committed to the use of a break in service sufficient such that it serves to maintain compliance with the Internal Revenue Code, demonstrates no pre-arranged agreement for reemployment and protects the trust fund by making it less likely that employees will retire earlier than anticipated to take advantage of return-to-work provisions. A six-month break in service, as provided in the substitute, is more likely to satisfy the IRS guidance than a shorter break is.

No Prearrangement for Re-employment

Importantly, regardless of the break in service period of time, the IRS requires that a member cannot have a prearranged agreement prior to retirement to return to employment. Thus, the longer the required separation from service is, the more likely the member and employer did not enter into a prearranged agreement for reemployment.

Importance of Maintaining Plan Qualification

Failure to meet the facts and circumstances test for a bona fide break in service could jeopardize VRS' plan qualification status, thereby affecting all members and retirees. Qualification as a governmental plan allows pre-tax employee contributions and exemption from taxation on investment earnings, among other tax benefits. Historically, investment earnings fund approximately 2/3 of benefit costs. In addition, if the IRS were to determine that a separation in service has not taken place, plan distributions to a retiree younger than age 59 ½ would incur a 10% tax penalty payable by the retiree, not the plan.

Affordable Care Act Implications

While VRS does not administer healthcare, our understanding is that all positions in educational institutions require a 26-week separation before returning to service with the same employer in order to avoid a potential ACA tax penalty; the break for non-educational institutions when an employee is returning to the same employer is 13 weeks.

DHRM has provided guidance to state employers related to the ACA break in service. Other VRS participating employers must rely upon their own benefits counsel or human resource departments for ACA guidance. VRS participating employers are strongly encouraged to consult their human resource departments or DHRM in the case of state agencies for further information.

This substitute is similar to HB 1630, SB1411 and SB 1479.

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