Virginia Retirement System

2024 Fiscal Impact Statement

1. **Bill Number:** SB 548

   House of Origin ☒ Introduced ☐ Substitute ☐ Engrossed

   Second House ☐ In Committee ☐ Substitute ☐ Enrolled

2. **Patron:** Craig

3. **Committee:** Finance and Appropriations

4. **Title:** Virginia Retirement System; return to work; break in service.

5. **Summary:** Reduces, from six months to one month, the length of the required break in service after retirement for a teacher, bus driver, specialized student support instructor, or law-enforcement officer before such person may return to work full time and continue to receive his pension under the Virginia Retirement System (VRS).

6. **Summary of Impacts**

   Benefit(s) impacted: The bill changes the break-in-service requirement from six months to one month for retirees who return to work full-time in a critical shortage position under § 51.1-155(B)(3) or as a school security officer under § 51.1-155(B)(4). Allows retired law-enforcement officers to return to work full-time in a law-enforcement officer position under § 51.1-155(B)(4) in addition to being able to return to work as a school security officer.

   Impact to unfunded liability (see Item 8 and Item 9 for details): The provisions of this bill are expected to change retirement patterns of future retirees and therefore will likely add to the unfunded liabilities of the impacted plans. The shorter the break in service required, the more likely it is that active employees will be incentivized to retire earlier than anticipated. As participant behavior is difficult to model when there is no credible data available, two estimates are being provided to demonstrate the range of potential impacts for Teachers, SPORS, and VaLORS plans:

   - On the low end, we modeled a 15% increase in retirements at every age, and also assumed that all plans impacted would have a five-year reduction in the last exit age for retirees.
     - VRS estimates unfunded liabilities under this scenario could increase approximately $416 million across the Teacher, SPORS, and VaLORS plans.
   - On the higher end, we modeled that all members will retire upon reaching unreduced retirement eligibility.
     - VRS estimates unfunded liabilities under this scenario could increase approximately $2.5 billion across the Teacher, SPORS, and VaLORS plans.

   Note, that local employers who employ hazardous duty members would also see impacts to the unfunded liability of their plan. Impacts will vary by employer.

Impact to contribution rate(s) (see Item 8 and Item 9 for details): To account for the changing of retirement patterns, assumptions used in the valuations will need to be updated to anticipate members retiring earlier than they would have without the opportunity return to work within a month. This will increase plan liabilities and the normal cost rate in order to properly fund for these increased costs.

As participant behavior is difficult to model when there is no credible data available, two estimates are being provided to demonstrate the range of potential impacts for Teachers, SPORS, and VaLORS plans:

- On the low, end we modeled a 15% increase in retirements at every age, and also assumed that all plans impacted would have a five-year reduction in the last exit age for retirees.
    - VRS estimates annual contributions under this scenario could increase approximately $41 million across the Teacher, SPORS, and VaLORS plans.
- On the higher end we modeled that all members will retire upon reaching unreduced retirement eligibility.
    - VRS estimates annual contributions under this scenario could increase approximately $246 million across the Teacher, SPORS, and VaLORS plans.

Note, that local employers who employ hazardous duty members would also see impacts to employer contributions. Impacts will vary by employer.

Specific Agency or Political Subdivisions Affected (see Item 10): VRS; all school divisions, and the political subdivisions that fund them; state or local employers who hire retirees as law-enforcement officers; and employers of current law-enforcement officers throughout the State.

VRS cost to implement (see Item 7 and Item 8 for details): Approximately $374,000 in FY 2024 primarily for programming and communications for new retiree positions, with minimal ongoing costs.

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 to all retirees enumerated in the bill and the addition of any law-enforcement position to § 51.1-155(B)(4).

As the timing of changes to retirement patterns cannot be readily determined, a revision to the contribution rates may be required in the second year of the biennium to reflect the impacts associated with employees retiring sooner than anticipated.

GF budget impacts (see Item 8 for details): General fund impacts will be dependent on the timing and magnitude of changing retirement patterns. As noted above, a modification of second year rates may be required to reflect the immediate impacts of members retiring sooner.

NGF budget impacts (see Item 8 for details): Approximately $374,000 in FY 2024 for VRS implementation, with minimal ongoing costs. Non-general fund impacts will be dependent on the timing and magnitude of changing retirement patterns. As noted above, a modification of second year rates may be required to reflect the immediate impacts of members retiring sooner.

7. **Budget Amendment Necessary**: Yes. Item 484. VRS will need a NGF appropriation of approximately $374,000 in FY 2024 for implementation costs, 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:** In the last biennium, the Governor and General Assembly appropriated approximately $1 billion to address unfunded liabilities. This bill is expected to generate significant unfunded liabilities thereby eroding the benefits of the prior infusions.

   Changes to return to work (RTW) rules lowering the required break in service from 12 months to six months were effective July 1, 2023, but not enough time has passed to see the long-term effects. RTW programs, especially ones with short break-in-service requirements, will influence active members to retire earlier than originally expected in order to enhance their immediate income by receiving both a retirement benefit and regular compensation.

   RTW proposals are difficult to model due to the lack of credible data on employee behavior related to these programs. To estimate potential impacts of lowering the required break in service from six months to one month we developed two scenarios in order to provide a range of possible outcomes.

SCENARIO ONE

Includes shortening the period of time over which we assume retirements will occur by five years. We effectively lowered the final age at which we expect all members to be retired from active service. The reductions were as follows:

- Teacher plan – reduced from age 80 to age 75.
- SPORS & VaLORS plans – reduced from age 70 to age 65.

In addition, the unreduced retirement decrements at all other ages were increased by a factor of 15%.

Below are the estimated impacts to unfunded liabilities associated with scenario one.

Liability Impacts – Additional $416.4 million in unfunded liability for the Teacher plan, SPORS and VaLORS. Local employers who employ hazardous duty members will also see impacts to liabilities in their plans.

Impacts to Unfunded Liabilities – Scenario One

Plan	Unfunded Liabilities 6/30/23	Estimated Unfunded Liabilities with Only One Month Break in Service for RTW	Estimated Increase in Unfunded Liabilities
Teachers	$11,950,839,000	$12,330,487,500	$379,648,500
SPORS	$449,999,000	$471,482,000	$21,483,000
VaLORS	$770,210,000	$785,518,500	$15,308,500
Total	$13,171,048,000	$13,587,488,000	$416,440,000

Below are estimates of increases in contribution rates associated with changes in retirement patterns assumed with only a one-month break in service requirement. Local employers who employ hazardous duty members will also see similar impacts to employer contribution rates.

Employer Cost Impacts – Additional $41.1 million in annual funding for the Teacher plan, SPORS and VaLORS. Local employers who employ hazardous duty members will also see impacts to employer cost rates in their plans. Increase in employer rates range from 0.34% for the VaLORS plan to 1.35% for SPORS plan.

Impacts to Employer Contribution Rates – Scenario One

Plan	Employer Contribution Rates 6/30/23 Valuation	Estimated Employer Contribution Rates with Only One Month Break in Service for RTW	Estimated Increase in Employer Contribution Rates	Estimated Increase in Annual Funding
Teachers	14.21%	14.58%	0.37%	$37,497,000
SPORS	31.32%	32.67%	1.35%	$2,268,000
VaLORS	22.81%	23.15%	0.34%	$1,334,000
Total				$41,099,000

SCENARIO TWO

Modeled 100% of members will retire upon reaching unreduced retirement eligibility. The eligibility for unreduced retirement is as follows:

- Teacher Plan – Plan 1: Age 50 with 30 years of service or age 65 with 5 years of service, whichever occurs first. Plan 2/Hybrid: Rule of 90 or age 65 with 5 years of service, whichever occurs first.
- SPORS and VaLORS – Age 50 with 25 years of service or age 60 with 5 years of service, whichever occurs first.

Below are the estimated impacts to unfunded liabilities associated with scenario two.

Liability Impacts – Additional estimated $2.5 billion in unfunded liability for the Teacher plan, SPORS and VaLORS. Local employers who employ hazardous duty members will also see impacts to liabilities in their plans.

Impacts to Unfunded Liabilities – Scenario Two

Plan	Unfunded Liabilities 6/30/23	Estimated Unfunded Liabilities with Only One Month Break in Service for RTW	Estimated Increase in Unfunded Liabilities
Teachers	$11,950,839,000	$14,240,869,000	$2,290,030,000
SPORS	$449,999,000	$617,060,000	$167,061,000
VaLORS	$770,210,000	$835,854,000	$65,644,000
Total	$13,171,048,000	$15,693,783,000	$2,522,735,000

Below are estimates of increases in contribution rates associated with changes in retirement patterns assumed with only a one-month break in service requirement. Local employers who employ hazardous duty members will also see similar impacts to employer contribution rates. Increases in employer rates range from 1.33% for the VaLORS plan to 11.67% for SPORS plan.

Employer Cost Impacts – Additional $245.9 million in annual funding for the Teacher plan, SPORS and VaLORS. Local employers who employ hazardous duty members will also see impacts to employer cost rates in their plans.

Impacts to Employer Contribution Rates – Scenario Two

Plan	Employer Contribution Rates 6/30/23 Valuation	Estimated Employer Contribution Rates with Only One Month Break in Service for RTW	Estimated Increase in Employer Contribution Rates	Estimated Increase in Annual Funding
Teachers	14.21%	16.39%	2.18%	$220,928,000
SPORS	31.32%	42.99%	11.67%	$19,677,000
VaLORS	22.81%	24.14%	1.33%	$5,295,000
Total				$245,900,000

Both of these scenarios will effectively shorten the period of time over which we expect members to work prior to retirement. The actual impact will be determined by observed behavior with respect to retiring early in order to collect both a pension benefit and regular pay. Note that these estimates do not contemplate members who are eligible for a reduced retirement benefit who also could choose to take advantage of an earlier retirement and returning to work. Therefore, the estimates provided here only include only those members eligible for an unreduced benefit. If an estimate was developed that also included members eligible for a reduced benefit, it would be higher than those provided here.

VRS currently reviews retirement decrements on a four-year cycle with the next review occurring in the Spring of 2025. Changes to retirement assumptions would happen over time as experience on member behavior under the new provisions evolved, and a more frequent review might be necessary in order to avoid additional unfunded liabilities to these plans.

Requiring employer contributions on RTW members helps mitigate cost impacts related to rate increases for the plans that include rehired retirees by ensuring the covered compensation over which costs are spread does not deteriorate due to filling VRS covered positions with non-active members.

However, these contributions do not protect against earlier retirements from the plans in which these members retire. Shortening the break-in-service to one month, allowing for receipt of a retirement benefit, full compensation, and access to subsidized active healthcare will likely influence a large portion of the active population eligible for unreduced retirement to do so under the provisions of this bill. There could also be members that would be incentivized to take a reduced retirement in order to take advantage of the additional income. It likely will not net additional active members, but instead will reclassify a portion of the current active population.

<u>Cash Flow Impacts</u>

In addition to the impacts on unfunded liability and employer annual cost shown above, the proposed changes could also cause a noticeable increase in the cash flow requirements of the VRS trust funds. VRS currently has cash flow requirements of nearly $6 billion per year. Legislation that alters retirement patterns could encourage those eligible for retirement but who had continued to work to start their retirement benefit when the legislation becomes effective. The exhibits below show the number of members who are eligible for retirement in the plans that could be affected.

Teachers Eligible for Retirement

		Teachers Eligible as of June 30, 2023				
	Total actives	**Eligible for full *unreduced* retirement**	**% of actives eligible for *unreduced* retirement**	**Eligible for reduced early retirement**	**Total eligible for retirement (reduced or unreduced)**	**% of actives eligible for retirement**
Teachers	153,151	8,116	5%	29,438	37,554	25%

Law-Enforcement Officers Eligible for Retirement

		Law Enforcement Officers Eligible for retirement as of June 30, 2023				
	Total actives	**Eligible for full *unreduced* retirement**	**% of actives eligible for *unreduced* retirement**	**Eligible for reduced early retirement**	**Total eligible for retirement (reduced or unreduced)**	**% of actives eligible for retirement**
Local HD	17,710	1,318	7%	1,774	3,092	17%
SPORS	1,920	312	16%	130	442	23%
VaLORS	1,868	167	9%	222	389	21%
Total	**21,498**	**1,797**	**8%**	**2,126**	**3,923**	**18%**

Below are the number of retirements by plan for the last five years. Using the Teacher plan as an example, we typically see slightly less than 5,000 new retirements each year. There are over 8,100 active Teachers who are eligible for an unreduced retirement as of June 30, 2023. To illustrate the maximum impact on cash flow for the Teacher Plan, if all teachers eligible for an unreduced benefit were to retire and RTW with a one month break, that would represent a 70% increase in the number of retirements we normally see each year, which would cause an unforeseen increase in cash flow requirements of the plan. A large increase in cash flow requirements could force VRS to liquidate invested funds at an inopportune time.

Number of Service Retirements by Fiscal Year

	Fiscal Year				
Plan	**2019**	**2020**	**2021**	**2022**	**2023**
SPORS	67	52	101	46	54
VaLORS	344	313	370	382	279
Teachers	4,671	4,323	5,000	5,121	4,758

More detail on the fiscal impact is explained in Item 9 below.

9. **Fiscal Implications:** The fiscal implications of changes to return to work rules have been discussed in several reports required by the General Assembly.

RD577- Return to Work Provisions for Certain Retirees to Work in Temporary Positions- Ch. 690, 707, and 708 of the 2023 Acts of Assembly- November 1, 2023

RD578- Return to Work for Law-Enforcement Officers Retired from VRS- Ch. 722 of the 2023 Acts of Assembly- November 1, 2023

RD856 (Published 2022) - Return to Work Provisions Governing Virginia Retirement System (VRS) Retirees – December 15, 2022

Section 401 of the Internal Revenue Code (IRC) establishes numerous requirements that VRS as a qualified governmental plan must comply with in order to qualify for favorable tax provisions[1]. 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.

A bona fide break in service before a retiree can return to work full time is necessary to comply with IRS guidance as well as to minimize any potential negative impacts from changing retirement patterns. It is not clear that a break in service of only one month prior to allowing a retiree to return to work full time would satisfy current IRS requirements. Shorter breaks in service also make it harder to demonstrate that there was no prearrangement to return to work, which is prohibited by the IRS and could also jeopardize VRS' plan qualification status. Further, a one-month break in service would be on the shorter end of breaks that are allowed by other retirement plans. Shorter breaks in service deployed in other states tend to be accompanied by additional provisions, such as income and hour limitations, stoppage or offset of the retirement benefit for specified periods, as well as age and service minimums. Rarely are shorter breaks in service deployed without also requiring additional restrictions.

<u>Critical Shortage and School Security Officer Positions</u>

Based on limited experience and data following the 2023 changes to the break-in-service requirements from 12 to six months, there has been a noticeable uptick in utilization. However, if only a one-month break in service was required, we would expect a significant uptick in members who would return to work following retirement. Tables 1, 2 and 3 show the number of retirees employed in critical shortage, bus driver, and school security officer positions. Current law does not allow a retired law-enforcement officer to return to work as a law-enforcement officer, though they may return to work as a school security officer.

[1] Tax Consequences of Plan Disqualification | Internal Revenue Service (irs.gov)

Table 1. Retirees Employed as Critical Shortage Teachers[2]

School Year	Number of retirees filling critical shortage teacher positions	Total teachers & administrators needed*	Total vacancies*
2008-2009	74		
2009-2010	53		
2010-2011	44		
2011-2012	44		
2012-2013	41		
2013-2014	38		
2014-2015	20		
2015-2016	17		
2016-2017	39	96,130	5,699
2017-2018	58	96,034	6,392
2018-2019	64	98,462	7,613
2019-2020	82	99,898	1,695
2020-2021	53	100,522	1,708
2021-2022	72	100,967	1,892
2022-2023	107	101,924	2,006
2023-2024**	160***		

Source: VRS data on retirees and VDOE data on teacher and administrator vacancies (may include additional positions not eligible for critical shortage RTW).
*VDOE data not available for 2008-2016; VDOE vacancy data in the table for 2023 and 2024 have not been updated.
**VRS data available through January 8, 2024. Note that in the same general time frame for the 2022-2023 school year there were 18 retirees filling critical shortage teacher positions.
***Effective July 1, 2023, "specialized student support positions" under § 22.1-253.13:2 (O) of the *Code of Virginia* are included in the critical shortage exemption. There are a total of four retirees in specialized student support positions included in the 2023-2024 count: one visual impairment specialist, two school counselors, and one behavior interventionist.

Table 2. Retirees Employed as Critical Shortage School Bus Drivers[3]

School Year	Number of retirees filling critical shortage bus driver positions	Total bus drivers needed	Total vacancies
2020-2021	20	2,440	281
2021-2022	20	1,847	467
2022-2023	27	2,761	596
2023-2024*	51		

Source: VRS data on retirees and VDOE data on bus driver vacancies; VDOE vacancy data in the table for 2023 and 2024 have not been updated.

[2] For a time, the critical shortage teacher program included speech-language pathologists. A subsequent statutory change to Va. Code § 54.1-2603 removed the requirement for speech-language pathologists to be licensed by VDOE, thus making the position ineligible for the critical shortage program. Very few retirees were employed as a speech-language pathologist under the critical shortage program, with the highest being four in one school year.
[3] VRS data does not include specific job titles to be able to determine how many retirees were formerly school bus drivers returning to the same position.

*Through January 8, 2024.

Table 3. Retirees Employed as Full-Time School Security Officers (RSSOs)[4]

Year	Number of retirees filling school security officer positions
2020-2021	10
2021-2022	14
2022-2023	26
2023-2024*	39**

Source: VRS data
*Through January 8, 2024.
**One school district accounts for 16 of the RSSOs in 2023-2024. The most any other school district has is five RSSOs.

As the data since the 2023 amendments took effect appear to indicate, 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, after a one-month break, receive a pension, and for retired law-enforcement officers, potentially a hazardous duty supplement, plus 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.

Further, because the teacher retirement plan is pooled (all employers pay the same rate), school divisions that have more teachers retiring and returning to work will essentially be shifting costs to school divisions that do not have large numbers of earlier than anticipated retirements.

As an example, the Teacher plan currently has approximately 3,500 members who have qualified for an unreduced retirement and are over either age 65 if in Plan 1, or Social Security Normal Retirement Age (SSNRA) if in the Plan 2 or Hybrid plan but continue to work. Assuming that just these members would retire immediately would increase the liability of the Teacher plan by approximately $100 million and increase annual benefits payments by about 2.0% per year, or approximately $50 million. The exhibit below provides the number of teachers who were eligible to retire as of June 30, 2023. The $100 million impact to unfunded liabilities is only associated with the 3,500 members over normal retirement age, and this is the minimum impact expected. Members from the group eligible for unreduced retirement but below normal retirement age would also likely be incentivized

[4] The COVID-19 pandemic, which began in the spring of 2020, led to a significant number of school divisions moving to virtual schooling in the 2020-2021 and fall of the 2021-2022 school years, thereby reducing the number of school buildings utilizing school security officers.

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 for a longer period of time. We also expect that members in the third group with eligibility for reduced benefits could 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.

Teacher Plan Active Population June 30, 2023

	Count	Percentage of Active Population
Total Actives	153,151	
Eligible for Full Unreduced Retirement Over Age 65/SSNRA	**3,503**	**2.3%**
Eligible for Full Unreduced Retirement Under Age 65/SSNRA	4,613	3.0%
Eligible for Reduced Retirement Under Age 65/SSRNA	29,438	19.2%
Total Eligible to Retire as of June 30, 2023	37,554	24.5%

Law-Enforcement Positions

In December 2023, as required by SB 1411 (Chapter 722) enacted during the 2023 Regular Session, VRS published a report reviewing options for allowing law-enforcement officers to return to work as law-enforcement officers after retirement. See RD578- Return to Work for Law-Enforcement Officers Retired from VRS- Ch. 722 of the 2023 Acts of Assembly-November 1, 2023. This report reviewed several potential return-to-work options for retired law-enforcement officers, including a six-month break-in-service provision.

Historically, the current retirement benefits afforded most law-enforcement officers in the Commonwealth (early retirement age; shorter service requirement; higher retirement multiplier; hazardous duty supplement) were designed to compensate for the risks, both physical and mental, experienced on the job by law-enforcement officers, as well as to permit earlier retirement of officers before there is any decline in their ability to physically perform the duties of a law-enforcement officer. Further, the hazardous duty supplement was designed to bridge the gap between hazardous duty employees' earlier retirement age and Social Security eligibility.

Law-enforcement officers employed by the Department of State Police are covered by the State Police Officers' Retirement System (SPORS) (Va. Code § 51.1-200 et seq.), and many other law-enforcement officers employed by the Commonwealth are covered by the Virginia Law Officers' Retirement System (VaLORS) (Va. Code § 51.1-211 et seq.). Local governments also have the option under Va. Code § 51.1-138 to provide enhanced hazardous duty benefits to their law-enforcement officers that are similar to those offered to State Police officers and such enhanced hazardous duty benefits must be provided to deputy sheriffs. Law-enforcement officers who are members of SPORS or VaLORS and local law-enforcement officers who are eligible for enhanced hazardous duty benefits have earlier age and service requirements for retirement eligibility than other VRS members. These law-enforcement officers become eligible for an unreduced retirement benefit at age 50 with at least 25 years of service credit or age 60 with at least five years of service credit and become eligible for a reduced retirement benefit as early as age 50 with five years of service credit.

The tables below provide the number of SPORS, VaLORS, and local hazardous duty members who were eligible to retire as of June 30, 2023. Members who have qualified for unreduced retirement are more likely to take advantage of return-to-work provisions and, as the exhibit shows below, represent about 8% of the current active hazardous duty population. We also expect that members in the third group with eligibility for reduced benefits could 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.

Table 7. Local Law Enforcement Active Population June 30, 2023

	Count	% of Active Population
Total Actives	17,710	
Eligible for Full Unreduced Retirement Age 60 or Older	544	3.1%
Eligible for Full Unreduced Retirement Under Age 60	774	4.4%
Eligible for Reduced Retirement Under Age 60	1,774	10.0%
Total Eligible to Retire as of June 30, 2023	3,092	17.5%

Source: VRS data

Table 8. SPORS Active Population June 30, 2023

	Count	% of Active Population
Total Actives	1,920	
Eligible for Full Unreduced Retirement Age 60 or Older	82	4.3%
Eligible for Full Unreduced Retirement Under Age 60	230	12.0%
Eligible for Reduced Retirement Under Age 60	130	6.8%
Total Eligible to Retire as of June 30, 2023	442	23.0%

Source: VRS data

Table 9. VaLORS Law Enforcement Active Duty Population June 30, 2023

	Count	% of Active Population
Total Actives	1,868	
Eligible for Full Unreduced Retirement Age 60 or Older	79	4.2%
Eligible for Full Unreduced Retirement Under Age 60	88	4.7%
Eligible for Reduced Retirement Under Age 60	222	11.9%
Total Eligible to Retire as of June 30, 2023	389	20.8%

Source: VRS data

The bill requires employers to include the members' salary in the computation of employer contributions, which will help mitigate any impact on contribution rates. While requiring employer contributions helps to mitigate a shrinking payroll, it will not help to diminish the negative impact of changing retirement patterns, which will increase liabilities and employer costs over time. The magnitude of the increase will be dependent on the volume of members who retire earlier than expected to later return to work under these provisions. 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, potentially a hazardous duty supplement, and active healthcare, as well as a full-time salary.

Under the bill, a retired law-enforcement officer, such as a SPORS member, could commence their retirement benefits and then return to work after a one-month break in service. For example, if the member was making $80,000 per year and had 25 years of service, they could commence their benefit of approximately $37,000 per year and continue to receive their annual compensation of $80,000 if they remained actively working. In addition, they would also receive the hazardous duty supplement, currently $16,884 per year, until they reach their Social Security normal retirement age. In sum, this hypothetical SPORS member would be receiving $133,884 per year, which would represent an increase in annual income of 67.4%. In addition, the member would likely be eligible for the health insurance credit. The member would also be eligible for COLAs, hazardous duty supplement adjustments, and pay increases going forward.

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, after a one-month break, receive a full-time salary, and employer-subsidized health insurance, it is likely that most retirement-eligible employees would pursue this option. It is important to remember that a law-enforcement officer could retire with a reduced benefit as early as age 50 with at least 5 years of service credit or with an unreduced benefit at age 60 with at least five years of service credit or age 50 with at least 25 years of service credit.

10. **Specific Agency or Political Subdivisions Affected:** VRS, public school divisions that employ retirees as critical shortage instructional or administrative employees or bus drivers, and who will employ retirees as specialized student support personnel, any employer who employs retired law-enforcement officers in any full-time law-enforcement position and political subdivisions that fund school divisions.

11. **Technical Amendment Necessary:** Yes. VRS is requesting that the effective date of this legislation be delayed until July 1, 2025, to allow for necessary systems adaptations along with necessary system validation testing. A delayed effective date will also allow for communications and outreach to affected employees and employers and updating web and handbook content.

12. **Other Comments:**

Overview

The bill reduces the bona fide break in service from six months to one month for existing critical shortage positions: teachers, school bus drivers, specialized student support personnel, and administrative employees, and for school security officer positions. The bill also permits retired law-enforcement officers to return to full-time work as a law-enforcement officer after a one-month break in service. The bill retains the current sunset in 2028.

Importance of Employer Contributions

Current law requires employer contributions for retirees who return to work, and would apply to the provisions of this bill. Employer contributions are 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, in some cases potentially a hazardous duty supplement (for law-enforcement officers), and, after a one-month break receive a full-time salary and employer-subsidized health insurance, it is likely that most retirement-eligible employees would pursue this option.

Significance of Required Break in Service

Prior to legislation enacted during the 2023 Regular Session, the limited exceptions in § 51.1-155 allowing retirees to return to work full time in certain positions required a 12-calendar-month break in service. The 12-month break in service requirement had been in place since 2001 when the critical shortage teacher program was first enacted and was the result of considerable analysis by VRS, the Joint Legislative Audit and Review Commission (JLARC), and VRS and JLARC actuaries. The 12-month break in service was 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. The history of and legal and actuarial basis for the 12-month break in service requirement was detailed in VRS' 2022 report: Return to Work Provisions Governing Virginia Retirement System (VRS) Retirees (RD856)-- December 15, 2022. Legislation enacted during the 2023 Regular Session reduced the 12-month break in service to six months (HB 1630 (Chapter 707), SB 1289 (Chapter 690) and SB 1479 (Chapter 708)).

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 break in service of only one month would be among the shorter breaks in service allowed by other retirement plans and would not clearly comply with IRS guidance. Other states that allow shorter breaks in service typically accompany that shorter break with other limitations, such as age, service, income restrictions, and benefit stoppage.

Break During Summer Months

There is no specific guidance from the IRS related to the timing of a break in service for school division employees for purposes of meeting the bona fide break in service requirement. However, 26 CFR § 1.410(a)-7 includes in the definition of "severance from service date" that time away from service following severance does not include vacation, holiday, sick leave, leave of absence, and other typically scheduled time away. Schools do not treat teachers as terminated during the summer break period when they will teach the following school year. Even for teachers or bus drivers who retire at the end of a school year, the last day of employment is not always clear for IRS purposes, as the last day of work is not typically the same as the teacher's retirement date and pay (if annualized) and benefits can be extended during the summer break period.

The IRS has recognized the unique nature of teacher summer breaks under the Affordable Care Act regulations by requiring that a specified number of hours during the break be taken into account for purposes of determining full-time status. Not allowing summer breaks to count toward the one calendar month break in service prior to returning to part-time employment has been a longstanding VRS policy position in order to best demonstrate that the IRS bona fide break in service rules are satisfied for teachers, and the language has been maintained after consultation with benefits counsel. Having such a provision helps to demonstrate that a true break in service has taken place.

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 less likely it will be that the member and employer had 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 Affordable Care Act (ACA) tax penalty.

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.

Law-Enforcement Benefits

As discussed in the 2023 report, numerous reports to the General Assembly have explained that enhanced retirement benefits, including early retirement, are required for law-enforcement officers (i) to compensate for the physical and mental stresses associated with their duties, which often necessitate that such officers have a shorter working life than other employees and (ii) to ensure that law-enforcement officers who remain on the job possess the physical and mental capabilities to perform their work and protect themselves and members of the public from injury. For example, a 1973 report, HD5 (1973) - Report of the Virginia

Advisory Legislative Council, State Police Compensation and Retirement, noted that "a relatively early retirement is necessary to protect citizens from officers who no longer possess the physical or mental attributes necessary to perform these complex and high stress tasks and to protect these older officers from possible serious injury due to decreased physiologic and psychologic capabilities."

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