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Faculty Retirement Incentive Programs: What Does the Law Permit?

by William D. Jewett on June 25, 2021

A recent survey of full-time college and university faculty found that, as of the beginning of the 2020-2021 academic year, approximately 25% of those surveyed expected to retire later than they had anticipated before the onset of the COVID-19 pandemic, and almost 40% of those aged 50-59 expected to retire later than they had thought before the pandemic. These figures correlate closely with the percentages of respondents reporting that they had become less confident during the pandemic of having enough money for a comfortable retirement.[1] At the same time, many institutions have been facing new financial stresses adding to the fiscal challenges that, even in the best of times, are posed by the reluctance of senior faculty to retire at what would be a typical retirement age in many other professions.

The survey findings may represent only a temporary period of anxiety resulting from the extreme volatility of the financial markets at the beginning of the pandemic. Even if this turns out to be a passing moment of uncertainty, it is a reminder that faculty are sensitive to changing circumstantial pressures when they think about retirement. The fact that a significant number quickly embraced the thought of delaying retirement may well give colleges and universities that are vulnerable to financial stresses a good reason to refresh their thinking about faculty retirement incentives.

Since the abolition of mandatory retirement for tenured faculty in 1994, faculty retirement incentive programs have become a permanent fixture at many colleges and universities. Over the past year, many colleges and universities have either considered or put in place new retirement incentives for tenured faculty.

Faculty retirement incentive programs vary greatly in design, but they generally offer a payment or series of payments to faculty of a certain age to relinquish tenure and retire, either at an agreed date or after an agreed period of part-time service. Institutions offering such programs face a maze of legal requirements that must be satisfied, in addition to having to create a design that meets their business needs and will be acceptable to their faculty. The main areas in which legal requirements must be observed are:

- The Age Discrimination in Employment Act (ADEA), which, with narrow exceptions, forbids the reduction or elimination of benefits for employees as they grow older;
- The Employee Retirement Income Security Act (ERISA), which, again with narrow exceptions, imposes demanding requirements on programs providing for retirement benefits;

- The federal income tax laws, which impose tax on compensation paid by tax-exempt employers as soon as the right to payment ceases to be subject to a substantial risk of forfeiture; and
- Other laws respecting discrimination in employment, together with other litigation risks.

The following is an overview of relevant legal requirements in these areas and a brief summary of other risks to keep in mind when considering a faculty retirement incentive program.

ADEA. Because encouraging faculty to retire earlier means discouraging them from retiring later, faculty retirement incentive programs typically offer financial incentives to retire that decrease or disappear as the faculty member's age increases. Such incentives would be starkly contrary to the requirements of the ADEA, if not for the availability of a safe harbor for tenured faculty at institutions of higher education. The ADEA safe harbor permits an institution to offer supplemental retirement benefits that are reduced or eliminated based on age, if:

- The benefits are payable only upon a voluntary retirement;
- No other benefits are reduced or eliminated;
- The supplemental benefits are in addition to other retirement or severance benefits available within the preceding 365 days; and
- Any tenured faculty member who satisfies the minimum age and other conditions for the benefit has an opportunity for at least 180 days to elect to retire and receive the maximum benefit that could be taken by a younger but otherwise similarly situated faculty member and has the ability to delay retirement for at least 180 days after making that election.

The last requirement is often referred to as the "one bite at the apple" rule, and it requires a program of this kind to give faculty members who age out of the maximum benefit before satisfying the program's service requirements one 180-day period to opt into the program and receive the maximum benefit by retiring within a second 180-day period. The application of this requirement can be complex, and it is very important to consult with experienced counsel when designing a program to fit within the safe harbor.

ERISA. It is often desirable for a faculty retirement incentive program to be subject to ERISA to avoid the application of state laws that may otherwise deem the program to discriminate illegally based on age. However, because pension plans are subject to a panoply of strict requirements under ERISA that faculty retirement incentives cannot satisfy, many faculty retirement incentive programs, by design, are made available only to a so-called "top hat" group of highly compensated or managerial employees, bringing the program within an exception that calls off most ERISA requirements. The case law on what constitutes a good “top hat” group is complex and it is advisable to consult counsel when establishing a program’s eligibility requirements.

If an institution wishes to provide retirement incentives for faculty who would not satisfy the requirements for membership in a “top hat” group, the institution can do so by adding special contributions or other provisions to an existing ERISA plan. Again, however, care must be exercised to avoid violating the many rules and requirements that apply to retirement plans subject to ERISA, which may include special rules for early retirement incentive programs offered through tax-qualified retirement plans.

It is also possible to avoid ERISA requirements for retirement plans by designing a short-term (window) retirement incentive program as a severance plan. However, the incentive payment amounts must be limited to the lesser of two times the faculty member’s annual compensation and two times the annual limit on compensation under a tax-qualified pension plan ($290,000 for 2021) and must paid out no later than the end of the second year following the year in which employment terminates.

Taxation. A faculty retirement incentive program should be designed to avoid exposing participants to tax on their benefits before those benefits are paid. This adverse result is possible because employees of tax-exempt organizations are subject to tax on items of deferred compensation as soon as the right to the compensation is no longer subject to a substantial risk of forfeiture. Phased retirement programs generally include a good substantial risk of forfeiture, in requiring continued service as a condition for the payment of benefits. Other programs, however, may need special features or contingencies to avoid adverse tax treatment for eligible faculty. In addition, institutions may need to consider possible tax consequences of benefits for the highest-paid participants, specifically under the “intermediate sanctions” rules relating to the reasonableness of compensation and under the new tax rules that apply to so-called “golden parachute” payments made to an institution’s top-paid employees.

Other legal risks. Faculty retirement incentive programs may run the risk of being designed or operated in a manner that could be considered discriminatory against a protected class, and care should be exercised when selecting eligible groups to avoid such discrimination. Most programs require participants to sign a special release of claims, and such releases may need to meet specific legal requirements to be enforceable. Programs of this kind also pose the risk of a participant claiming that the decision to retire was not voluntary, and they routinely run the risk that faculty who retired shortly before the program was announced will claim the benefit should be made available to them. Wherever such a program is accompanied by special employment-related rules, for example rules limiting recall appointments after participation in the program, there is a possibility that the enforcement of those rules may be viewed as selective or as discriminatory in operation. If a faculty retirement incentive program offers other benefits in addition to incentive payments (for example subsidized retiree medical and/or COBRA), the college or university must ensure that offering benefits to a select group of employees does not violate nondiscrimination rules and other legal requirements relating to those benefits. These are only a few of the risks that may arise in rolling out or amending a program of this kind.

As this brief discussion should make clear, colleges and universities that are considering a new or amended faculty retirement incentive program should exercise caution in designing their incentives, so that they do not run afoul of the numerous legal requirements and risks. For assistance in thinking through these requirements and risks as they may apply to your institution's circumstances and business needs, please contact a member of Verrill's Employee Benefits & Executive Compensation Group.

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[1] Melissa Fuesting, Stephanie Hale, and Paul Yakoboski, *Faculty Retirement Patterns and COVID-19: Impacts, Challenges and Opportunities*, CUPA-HR Webinar, May 26, 2021.

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