MARYLAND
DEPARTMENT OF
BUDGET & MANAGEMENT

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Lieutenant Governor

DAVID R. BRINKLEY
Secretary

MARC L. NICOLE
Deputy Secretary

January 1, 2019

Victoria L. Gruber
Executive Director
Department of Legislative Services
Legislative Services Building
90 State Circle
Annapolis MD 21401

Dear Ms. Gruber:

In accordance with the provisions of Chapter 774 (Personnel and Pensions – Phased Retirement Plan) of the Acts of the 2018 Session, I am submitting the required report on the development of recommendations for a phased retirement plan. This report has been developed by the Department of Budget and Management in consultation with the State Retirement Agency.

If there are any questions regarding the information provided in this report, please do not hesitate to contact me or Cynthia A. Kollner, Executive Director of the Office of Personnel Services and Benefits, at 410-767-4716.

Sincerely,

David R. Brinkley
Secretary

Enclosure

cc: R. Dean Kenderdine, Executive Director, Maryland State Retirement and Pension System
Cindy Kollner, Executive Director, Office of Personnel Services and Benefits, DBM
Barbara Wilkins, Director of Government Relations, DBM

MSAR 11664

45 Calvert Street • Annapolis, MD 21401-1907
Tel: (410) 260-7041 • Fax: (410) 974-2585 • Toll Free: 1 (800) 705-3493 • TTY Users: call via Maryland Relay
http://www.dbm.maryland.gov

Initial Report on Phased Retirement for the State Personnel Management System

In accordance with the provisions of Chapter 774 (Personnel and Pensions – Phased Retirement Plan) of the Acts of the 2018 Session, the Department of Budget and Management (the Department) and the State Retirement Agency (SRA) are required to submit a report and regularly scheduled follow ups on the development of recommendations for a phased retirement plan.

The initial report to the Department of Legislative Services is required on or before January 1, 2019, with a follow up report due on or before May 1, 2019. Thereafter, on or before July 1, 2019, the Department and the SRA are required to submit finalized recommendations for a phased retirement plan. Recommendations for suggested statutory changes to implement a phased retirement plan must be submitted on or before December 1, 2019.

The Objective of a Phased Retirement Program

Generally, phased retirement programs allow retiring employees to continue to work for a finite period of time at some part-time level of employment. These programs are designed to ease retiring employees out of the workforce while transitioning their institutional knowledge and critical duties to new or existing workers.

Phased retirement programs are not prevalent in the private sector. It appears that there are multiple reasons for the lack of enthusiasm for programs of this nature, including the fact that companies are concerned that such programs may open the door to age discrimination lawsuits and the fact that most companies do not provide post-retirement benefits, so keeping employees longer likely increases costs.

Although private industry is not keen on these types of programs, a number of post-secondary institutions and the federal government have implemented some form of phased retirement. In brief, the federal phased retirement program is voluntary and permits eligible full-time employees within the Civil Service Retirement System and the Federal Employees Retirement System to reduce their percentage of employment to half-time. The participating employee receives half of the employee's normal salary and half of their retirement annuity. A participant has to meet certain eligibility criteria in order to participate. The main focus of the federal program is to perform knowledge transfer activities.

Retirements in the State Personnel Management System (SPMS)

Since 2010, an average of 1,300 employees has retired from State employment each year.

SPMS Retirements	
Fiscal Year	**Count**
FY10	1,584
FY11	1,945
FY12	1,201
FY13	1,323
FY14	1,184
FY15	1,570
FY16	1,471
FY17	1,370
FY18	1,577

While retirements present an opportunity for State agencies to restructure jobs, rework processes and even downsize through attrition, it is undeniable that the retirement of key employees can have an adverse impact on agencies. The failure to adequately plan for the transition of knowledge and duties of key employees can require months of work before an agency's work flow equilibrium is restored. A phased retirement program allows agencies to operate without significant advanced planning for retiring key employees.

Alternatively, sometimes the failure of an agency to plan for the departure of a long term employee can be beneficial to an agency. The knowledge gap created by the departure of the key employee forces an agency to rethink and reengineer its processes instead of mindlessly mirroring what always has been done. Not having an incumbent to guide the continuation of the same process may cause the remaining employees to design new processes that typically will be the most efficient for the agency's current state.

The Cost of a Phased Retirement Program

Costs of a phased retirement program really depend on how they are structured. For the SPMS, the primary cost driver would be the additional salary dollars from the overlapping position. Under a phased retirement scenario, the retiring employee would overlap with the new employee for a period of months. The agency would then incur additional salary costs associated with the overlap period.

As an example, an agency would budget for a key PIN at its normal funding level. When the retiring employee agrees to remain employed on a 50% basis in the phased retirement program for six months, the agency will have 1.5 times salary cost for that PIN. If the PIN was budgeted at $100,000, the cost of the position then becomes approximately $150,000, assuming the salary of the retiring employee and the replacement is roughly equivalent. However, without adequate controls, a phased retirement program could quickly drive agency budgets into a deficit scenario.

CURRENT BARRIERS TO PHASED EMPLOYMENT

Both the Maryland State pension law and the federal tax laws have provisions in place that would prohibit an employee from partially retiring and continuing to work for the State in a part-time capacity. These provisions include:

1. Limitations on Reemployment

The Internal Revenue Service (IRS) can impose significant tax penalties on employees and serious tax consequences on the State Retirement and Pension System (System) if employees retire before the normal retirement age of their plan and/or before age 59 ½, and are reemployed with the same employer without a bona fide separation of service. For purposes of determining normal service retirement age for the System, normal service retirement age would vary depending on the plan and the date of enrollment in the plan. For example, normal service retirement age in the EPS and TPS is 62 if an individual became a member of either plan before July 1, 2011. Individuals becoming members of the EPS or TPS on or after July 1, 2011 have a normal retirement age of 65. Other variances in the normal retirement age are found throughout each of the other plans in the System. This could be problematic when developing a phased retirement plan for members of the System, since according to Treasury Regulations, the Internal Revenue Code (IRC) does not recognize a partial retirement, and accordingly, would not permit distributions due to a reduction in hours under a phased retirement plan, if the member has not reached normal service retirement age. For the purpose of defining an employer, all units of Maryland State government, including the University System of Maryland, are considered one employer.

Additionally, while the IRS has not specifically defined what constitutes a bona fide separation from service, it is clear that the greater the difference between an employee's last job before retirement and the job being performed upon reemployment, and the longer the break between the date of retirement and the date of reemployment, the more likely it is that there has been a break from service.

Maryland retirement law requires that employees wait at least 45 days before accepting employment with any participating employer. Additionally, employees reemployed to perform the same job, even if there is a reduction in work schedule, likely would not qualify as having had a bona fide separation of service unless there was a lengthy break in employment. Even arrangements where an employee is rehired as an "independent contractor" may not meet the IRS standard.

2. **Earnings Limitations**

Even once an employee has a bona fide separation of service, the majority of employees will be subject to earnings limitations which results in an employee's monthly payment being reduced one dollar for each dollar earned in excess of the limit.

CURRENT EXCEPTIONS TO EARNING LIMITATIONS

The limitation on earnings after retirement has a chilling effect on the reemployment of retired workers; however, there are large groups of workers who are currently excluded from those limitations after the 45day break in service. These include:

1. Health Care Practitioners: Includes retirees who are reemployed on a contractual basis by the Department of Health as a health care practitioner in a state residential center, a chronic disease center, state facility, or a local health department. Employees who retire early still have an earnings limitation for the first 12 months.

2. Parole and Probation Employees: Includes retirees of the Employees' Retirement or Employees' Pension Systems who are reemployed on a contractual basis for not more than four years as a parole and probation employee in a position with the Division of Parole and Probation in the Department of Public Safety and Correctional Services. Employees who retire early still will have an earnings limitation for the first 12 months.

3. Correctional Officers: Includes retirees who are reemployed on a contractual basis by the Division of Corrections, the Division of Pretrial Detention and Services or Patuxent Institution in the Department of Public Safety and Correctional Services as a correctional officer in a correctional facility for not more than four years.

4. Teachers and Principals: Includes retirees who are reemployed as a classroom teacher, substitute teacher or teacher mentor in a public school who meet certain specific requirements or for the Maryland School for the Deaf, and who are teaching in an area of critical shortage, a special education class for students with special needs, or a class for students with limited English proficiency. Employees who retire early still have an earnings limitation for the first 12 months.

5. State Police: Includes retirees of the Maryland State Police who accept permanent or contractual employment, unless reemployed on a contractual basis at the rank of Trooper First Class for more than four years.

These exceptions appear to incentivize retirees in hard to recruit and retain classifications to return to the workforce; however, no such incentives or options exist for other employees to remain in the workforce – even if in a limited capacity – without a break in service and a limitation on earnings.

Recommendations for the SPMS

Despite the drawbacks of a phased retirement program, such as potential cost overruns and stunted process reengineering, such a program could have definite benefits for the SPMS if it is implemented on a limited basis for employees in key positions. Key positions are those having expert knowledge in a functional area critical to the agency mission.

To avoid the tendency to simply reestablish current processes, employees participating in this phased retirement program would be required to work with their replacement to:

a. Help them understand the job requirements and stakeholder needs; and
b. Assess current processes and revise as needed to ensure maximum efficiency given the current agency processes.

The period of participation in this program would be limited to eight months to avoid cost overruns and to ensure the transition of work to the replacement. Eight months seems a reasonable amount of time to accomplish a full transition of duties. As with all other models of phased retirement, the program must be voluntary, and the appointing authority must approve the employee's participation. An appointing authority should be consistent in determining whether an employee who is otherwise eligible to participate may participate in the phased retirement program.

The program should be set up so that participants in the program are partially retired and receive some portion of their pension annuity while working part-time and receiving an equivalent percentage of their regular pay. Agencies would have the discretion to determine the percent of employment that retired employees will continue to work. The benefit to retiring employees is that they begin to receive pension disbursements from the State and continue to work and receive pay without having to make pension contributions or be subject to an earnings limitation. However, prior to setting up a program, the Department and SRA would need to seek guidance from tax counsel to address the issue of service retirement distributions and normal service retirement. In light of the prohibition of distributions prior to normal service retirement age, it would be helpful to receive guidance on whether a phased retirement program would satisfy provisions of the IRC if participation was limited to members who had reached normal service retirement.

Depending on the advice received by tax counsel, the State pension law regarding State employee retirement and pensions will need to be amended to allow for such a program and to ensure that participating employees will not be subject to an earning limitation. Additionally, the 45-day break in service that is currently required for all System retirees returning to work for a participating employer will also need to be amended. The SRA also anticipates that there may be a need to seek a private letter ruling from the IRS prior to implementing a phased retirement program, in order to confirm that the program would not jeopardize the System's tax-qualified status. The legislature should expect this process could take at least a year.

Since the program is a voluntary agreement between the employee and employer, a participant in the phased retirement program should be permitted to voluntarily fully retire at any time prior to the scheduled end date of the employee's participation in the program. Recognizing that the employer may have set into motion other organizational or operational changes in anticipation of the participant's impending full retirement, a participant who wishes to terminate participation in the program and return to full employment status will require the appointing authority's approval to do so. If the employee's request to return to regular employment is not approved, the employee should have the option to continue to work as a phased retiree for the remainder of the time specified in the phased retirement agreement or enter full retirement.

Additionally, it is recommended that the program include an option to permit an agency to unilaterally cancel a phased retirement agreement. If the agency does so, the employee should have the option to return to full time employment or enter retirement status.

Since the approval of a request for participation is discretionary, neither the denial of a request to participate in program, nor the unilateral cancellation of an employee's participation in it is an action that is subject to appeal as an adverse personnel action, nor does it raise an issue that is subject to the Title 12 grievance process.