LARRY HOGAN
Governor

BOYD K. RUTHERFORD
Lieutenant Governor

Maryland
DEPARTMENT OF BUDGET AND MANAGEMENT

DAVID R. BRINKLEY
Secretary

MARC L. NICOLE
Deputy Secretary

December 1, 2019

The Honorable Melony Griffith
Chair, Joint Committee on Pensions
220 James Senate Office Building
Annapolis MD 21401

The Honorable Ben Barnes
Chair, Joint Committee on Pensions
151 House Office Building
Annapolis MD21401

Dear Chair Griffith and Chair Barnes:

In accordance with the provisions of Chapter 774 (Personnel and Pensions – Phased Retirement Plan) of the Acts of 2018 Session, I am submitting the required report on statutory changes to implement a phased retirement program. 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 or cindy.kollner@maryland.gov

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 # 11666

FINAL 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 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 program. This is the final of four required reports on the implementation of a phased retirement program in the State Personnel Management System (SPMS). The initial reports to the Department of Legislative Services were submitted on January 1, 2019, May 1, 2019, and July 1, 2019. Per the legislation, this report provides recommendations for statutory changes to implement a phased retirement program.

BACKGROUND

Phased retirement programs are generally designed to allow retiring employees to continue working for a finite period of time at some part-time level of employment. These programs are tailored to ease retiring employees out of the workforce while transitioning their institutional knowledge and critical skill set to new or existing workers. Employees are usually required to meet certain eligibility criteria to participate. Participating employees often receive half of their normal salary and half of their retirement annuity while in phased retirement.

Retirements present an opportunity for State agencies to restructure jobs, rework processes and even downsize through attrition, but it is undeniable that retirement of key employees can have an adverse impact on agencies. If key employees, or individuals that have critical knowledge and expertise, exit the workforce without conducting knowledge transfer activities, their absence could impact the agency's ability to meet mission critical objectives. Understanding the General Assembly's desire to implement a phased retirement program, the Department considered a program that limited participation to key employees, given the potential impact of retirement of these positions on an agency's workflow.

ADDRESSING BARRIERS TO PHASED RETIREMENT

Both the Maryland State pension law and the federal tax laws have provisions in place that would inhibit an employee from partially retiring and continuing to work for the State in a part-time capacity. The following are identified barriers to the implementation of a phased retirement program and proposed remedies, if a phased retirement program is pursued.

Limitations on Reemployment

A successful phased retirement program would allow an employee to continue to work for the same employer at reduced hours while receiving partial salary and partial pension payments. However, the Internal Revenue Service (IRS) can impose significant tax penalties on employees and serious tax consequences on the State Retirement and Pension System (SRPS) if employees retire before the normal retirement age (NRA) of their plan and/or before age 59 ½ and are reemployed with the same employer without a bona fide separation of service.

The Internal Revenue Code (IRC) does not permit distributions due to a reduction in hours if a member has not reached NRA or age 62. However, the IRC does provide a safe harbor permitting a plan to allow pension distributions during employment if an employee attains age 62[1]. Therefore, it would be practical to restrict eligibility for a phased retirement program only to State employees who have reached age 62 and are eligible for a normal service retirement allowance. To utilize the safe harbor, State law would need to be amended to explicitly allow for in-service pension distributions while an employee is still employed once the employee has attained age 62.

Absent a permissible exception such as age 62 safe harbor described above, the IRC requires that employees have a bona fide separation from service in order to retire and commence receiving distributions. Maryland law requires employees to wait at least 45 days after the effective date of retirement prior to accepting reemployment with any participating employer[2]. As further discussed below, Maryland pension law also generally imposes an earnings limit on retirees who return to work for a participating employer. The IRS has not specifically defined what constitutes a bona fide separation from service, but 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, the more likely it is that there has been a break from service. As noted above, however, under the IRC, a plan can permit in-service distributions without a bona fide separation from service after a member has attained age 62. The State Personnel and Pensions Article of the Maryland Annotated Code would need to be amended to allow eligible phased retirement participants to continue working for the same employer without a bona fide separation and in a part-time capacity.

Caution is advised prior to any legislative changes, and tax counsel should be consulted regarding any legislative proposal. According to SRA, a private letter ruling from the IRS would be prudent to confirm that a phased retirement program would not jeopardize SRPS tax-qualified status, but the IRS may not issue a letter at this time. The IRS has issued a notice of proposed rulemaking for the applicability of NRA to governmental pension plans. The proposed regulations would offer guidance on the definition of NRA in the public sector, which tends to have a greater variety of NRAs than the private sector. For instance, members belonging to public safety pension plans often have NRAs younger than age 62. Even hire date can mean differences in NRA for employees in the same pension systems. For example, retirees in the Employees' Pension System or Teachers' Pension System hired before July 1, 2011 have a NRA of 62, while employees hired on or after July 1, 2011 have a NRA of 65.

Fiscal Considerations

The cost of a phased retirement program will depend on how it is structured. For SPMS, the primary cost driver would be the additional salary dollars from an 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. That is to say, the agency would be paying 1.5 times the salary for one position where two people are occupying the same PIN.

---

[1] *See* 26 U.S.C. § 401(a)(36) (West 2018).

[2] State Personnel and Pensions Article §22-406(d), §23-407(d), §24-405(d), §25-403(h), §26-403(f), and §27-407(e).

In addition to salary costs, day-to-day operational costs could increase as well. Employers would need to find office space, computers, and office equipment for two employees sharing one PIN.

There are design elements that may limit the State's cost exposure if a phased retirement program is implemented. The time period of participation in a program could be limited to within a fiscal year to avoid costs impacting multiple budgets. Additionally, approval of a phased retirement agreement could be subject to availability of funding in an agency's budget. Alternatively, the State could limit phased retirement eligibility only to scenarios where the retiring employee and chosen successor work in the same unit and could undertake the mentoring process without additional costs (assuming the successor stays in their original PIN until the retiring employee is fully retired).

The State could also consider limiting participation in a phased retirement program to certain employee groups or departments that have high percentages of workers eligible to retire. For instance, Management Service (MS) had the highest percentage of employees eligible for retirement (25%) as of June 2019. A phased retirement program could be limited to employees in MS, recognizing the population eligible for retirement as well as the fact that many employees in MS could be potentially key employees. However, this narrow focus does not acknowledge that key positions can also be found in other service distinctions. While limiting participation to a phased retirement program could save on cost, the State may want to consider how many employees will actually benefit from the program in comparison to the administrative burden of implementing it.

OTHER CONSIDERATIONS

Earnings Limitations

Under State law, even after a bona fide separation of service, the majority of employees will be subject to earnings limitations. This limitation is imposed if the retiree's initial annual basic allowance plus salary from the new position exceeds the retiree's average final compensation used to compute the basic allowance at retirement. If it does exceed the retiree's average final compensation, the retiree's current benefit is reduced dollar for dollar in an amount equal to the excess. There are certain groups of workers who are currently excluded from these limitations in reemployment after the 45 day break in service (*i.e.* health care practitioners, parole and probation employees or correctional officers rehired on a contractual basis, teachers and principals, and State police rehired on a permanent or contractual basis). 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.

The General Assembly could create a specific earnings limitation exemption for retirees participating in a phased retirement program. Depending on the intent and design of a phased retirement program, an exemption may not be necessary if the individual's salary and allowance do not exceed the retiree's average final compensation. Depending on the plan design, an exception to earnings limitation for employees participating in a phased retirement program could incentivize them to double dip, by collecting both a retirement annuity and a full-time salary.

Defining Key Employees

In our May 1, 2019 report, the Department indicated that a representative sampling of the State's largest agencies were surveyed to request that each identify key personnel within their organizations. In addition to looking at the Department's positions, we requested information on key personnel within the following departments: Health; Human Services; Juvenile Services; Public Safety and Correctional Services; Natural Resources; and State Police. The responses were vastly different, with one agency identifying almost 500 positions as key, while another identified only four key positions. The results of the survey make it clear that there is a lack of understanding of what role a key employee plans in an organization, and interpretation is entirely subjective. The Department would need to carefully refine the definition of a key employee in order to implement an effective phased retirement program. Oversight to ensure that appointing authorities within different agencies are applying definitions and determining eligibility in the same way would be difficult.

Financial Impact on Employees and Retirees

Depending on how a phased retirement program is designed, participants could experience a reduction in pension and Social Security benefits upon full retirement. If participants' annuity benefits are recalculated incorporating their service while in phased retirement, their monthly pension annuity would be lower than if the employee decided to continue working as a full-time employee due to the absence of pension contributions and accrual of any additional service credit during phased retirement. Current pension law prohibits a retiree from earning any further SRPS benefits from post-retirement employment, and also exempts the retiree from paying additional contributions on post-retirement earnings with a participating employer.

Additionally, Social Security benefits could be negatively impacted as a result of the reduction in salary. The Social Security Administration maintains a list of an employee's annual earnings, up to each year's Social Security maximum taxable wages. Each year is indexed for inflation, and the top 35 years are averaged together and divided by 12 to determine average indexed monthly earnings. If an employee elects to work part-time as opposed to full-time, and the time employed falls within the top 35 years, it would result in reduced Social Security benefits. However, if an employee elects to work part-time as opposed to not working, then benefits would increase. The impact of participation in a phased retirement program to Social Security benefits would be unique to each employee, requiring careful financial consideration before entering into such an agreement.

Financial counseling of retirees of potential impacts on their retirement benefits prior to entering into phased retirement would be recommended, and participation would likely be most appealing to employees who make higher salaries. Besides the potential reduction in pension and Social Security benefits, only employees who are able to work at a reduced income would be viable candidates for a phased retirement program. Given the generally low level of savings the American workforce has for retirement, it is likely that many employees will want to work full-time to maximize earnings prior to retiring fully.

RECOMMENDATIONS

The Department believes the State would receive limited benefit from a phased retirement program while having to invest significant resources in changing the statute and managing the program. Given the uncertainty with the IRS proposed rules on NRA in the public sector, the potential for cost overruns in State agencies, and administrative burdens in comparison to the benefits, the Department of Budget and Management does not recommend any statutory changes to implement a phased retirement program at this time.

ALTERNATIVE TO PHASED RETIREMENT

The Department believes that a more advantageous option than phased retirement is to invest resources in a renewed emphasis on workforce and succession planning. The goal of workforce and succession planning is similar to that of a phased retirement program. In both cases, the employer is attempting to plan for the future by identifying and anticipating knowledge and skill gaps. Ongoing workforce and succession planning encourages a collaborative process among agencies and employees and does not simply target individuals who reach a certain age. Unlike phased retirement, workforce planning acknowledges that key employees are found at all levels of State service, and the focus should be to attract and retain talented employees while also planning for transitions and knowledge transfer should these employees retire or resign. Workforce and succession planning is also a more flexible approach than phased retirement, given the way in which a phased retirement program would have to be structured and limited.

Succession planning focuses on identifying key leadership positions within the agency and taking steps necessary to develop employees to assume responsibilities as positions are vacated. In order to effectively develop succession plans to fit agency needs, it is necessary to perform a gap analysis to determine whether and how many qualified or potentially qualified internal candidates are present within the organization. Based on the survey results and obvious confusion among agencies over what constitutes a key employee, increased workforce and succession planning education could be worthwhile.

Succession planning can also be more inclusive than phased retirement. Where phased retirement typically pairs one outgoing employee with a successor employee, succession planning builds a "bench" of talent with multiple employees developing the capabilities to take over a variety of tasks. Within the State's merit system framework, a succession planning model is a better tool for establishing a pool of talent that provides employees with equal opportunity for training, development and promotions. Employees not chosen as a successor under a phased retirement program may become discouraged and resign if promotional and development potential appears limited. Phased retirement programs may also discourage State agencies from doing active workforce and succession planning, with agencies deciding to use phased retirement transitions as stopgap measures while they find a solution to replacing a key employee.

For these reasons, the Department recommends the State pursue a renewed emphasis on workforce and succession planning as an alternative to a phased retirement program.