MARYLAND
DEPARTMENT OF
BUDGET & MANAGEMENT

LARRY HOGAN
Governor

BOYD K. RUTHERFORD
Lieutenant Governor

DAVID R. BRINKLEY
Secretary

MARC L. NICOLE
Deputy Secretary

July 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 General Assembly 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 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,

Marc Nicole for

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

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THIRD REPORT ON PHASED RETIREMENT
FOR THE STATE PERSONNEL MANAGMENT SYSTEM

In accordance with the provisions of Chapter 774 (Personnel and Pensions – Phased Retirement Plan) of the Acts of the 2018 General Assembly 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 recommendations for a phased retirement plan.

This is the third in a series of four required reports on the implementation of a phased retirement program in the State Personnel Management System (SPMS). The initial report to the Department of Legislative Services (DLS) was submitted on January 1, 2019 with a May 1, 2019 follow up report. This report, which is due by July 1, 2019, offers finalized recommendations for a phased retirement plan. On or before December 1, 2019, recommendations for suggested statutory changes to implement a phased retirement plan shall be submitted.

BACKGROUND

Phased retirement programs are designed to allow retiring employees to continue working for a finite period of time, usually several weeks to several months, while mentoring and teaching the newly hired successor employee. These programs are tailored to ease retiring employees out of the work force while transitioning their institutional knowledge and critical skill set to new or existing workers.

Understanding the General Assembly's desire to implement a phased retirement program, we recommended a model that focuses on "key" employees. We defined key employees as individuals having critical knowledge and expertise about a crucial aspect of the agency's mission. If key employees exit the workforce without conducting knowledge transfer activities, their absence could impact the agency's ability to meet mission critical objectives.

FOLLOW-UP ITEMS

In our May 1, 2019 report, we indicated that we surveyed a representative sampling of the State's largest agencies to request that each identify key personnel within their organizations. In addition to looking at DBM 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 this survey make it clear that there is a lack of understanding of what role a key employee plays in an organization. We would need to carefully refine the definition of a key employee in order to implement an effective phased retirement program.

We also shared our initial phased retirement plan recommendations with three of the exclusive representatives of bargaining unit employees. We contacted the American Federation of Teachers (AFT), Healthcare – Maryland, Maryland Professional Employees Council, and the American Federation of State, County and Municipal Employees. These three organizations represent the vast majority of bargaining unit positions within the SPMS. No response was received from any of the exclusive bargaining representatives.

BARRIERS TO PHASED RETIREMENT

The State Personnel and Pensions Article of the Maryland Annotated Code includes a provision that essentially prevents the creation of a phased retirement program. This provision prohibits an employee from retiring and continuing to work for the State in a part-time capacity.

Additionally, federal tax law imposes certain restrictions that prevent a qualified plan from paying a benefit before a member: (a) terminates employment; or (b) reaches the plan's normal retirement age, or age 62 or some later age. These provisions include normal retirement age restrictions, required bona fide separation from service, and reemployment earnings limits.

Normal Retirement Age Restrictions and Required Bona Fide Separation from Service

The Internal Revenue Service (IRS) can impose significant 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 re-employed with the same employer without a bona fide separation of service. Normal retirement age for the System varies depending on the plan and the date of enrollment in the plan. For example, normal service retirement age in the Employees' Pension System (EPS) and the Teachers' Pension System (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.

The Internal Revenue Code (IRC) would not permit a qualified plan to allow distributions due to a reduction in hours under a phased retirement plan, if the member has not either reached the plan's normal retirement age, or age 62 (or some later age). Importantly, State law would need to be amended consistent with IRC requirements in order to permit distributions before termination from employment. Also, importantly, there still may be an early distribution penalty owed by the employee if the employee is younger than age 59 ½ and does not meet an early distribution exception (primarily, if the employee does not have a bona fide separation of service). For purposes of defining an employer, all units of Maryland State government, including the University System of Maryland, are considered one employer.

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 bona fide break in service.

In order to comply with the federal requirement for a bona fide break in service, Maryland requires that employees wait at least 45 days before accepting employment with any participating employer.[1] Additionally, employees re-employed 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.

Reemployment Earnings Limitations

In addition to having to satisfy Maryland's 45-day break in service requirement, the majority of the retirement and pension plans within the System also impose an earnings limitation on retirees of these plans who, within five years of retiring, return to employment with the same participating employer of the System from which they retired. Generally, this limitation is imposed if the retiree's initial annual basic allowance plus salary from the new position exceed the retiree's average final allowance 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. In response to the financial hardship the earnings limitation may have on reemployed retirees, numerous pieces of legislation have been enacted over the years to exempt several groups of retirees from this limitation. 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

[1] In reference to the 45-day break in service currently required under Maryland law, it should be noted that Chapter 483 of the Laws of Maryland 2019 allows two members of the System who are dually employed by participating employers of the System to retire from one position and continue working in the second without the required 45-day break in service. Tax counsel for the System reviewed the specific circumstances for each member included in Chapter 483 and determined that since each was over normal retirement age/age 62, the plan could be amended to permit in-service distributions to them. Should the Legislature choose to move forward in its development of a phased retirement program, it may wish to look to Chapter 483 for guidance with regard to the issue of mandatory breaks in service following a member's retirement from the System and returning to work for a participating employer.

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 Department of Public Safety and Correctional Services. Employees who retire early 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 the 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 of 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.

6. **Judges**: Includes retired judges who are temporarily assigned to sit in a court of this State under the authority of Article IV, § 3A of the Maryland Constitution and retired judges who are employed as members of the faculty of a public institution of higher education in the State.

7. **Law Enforcement Officers and Legislators**: The Law Enforcement Officers' Pension System and the Legislative Pension Plan do not include provisions that impose an earnings limit on retirees of these pension plans.

These exceptions appear to incentivize retirees in hard-to-recruit/hard-to-retain classifications to return to the workforce; however, no such incentive or options exist for other employees to remain in the work force – even in a limited capacity – without a break in service or a limitation on earnings. That being said, the General Assembly should be aware that, unlike the IRS restrictions preventing a plan from allowing in-service distributions before a plan's normal retirement age or age 62, the IRS does not require plans to impose an earnings limitation on retirees who return to employment with a participating employer. Accordingly, the General

Assembly could create a specific earnings limitation exemption for retirees participating in a phased retirement program.

However even if the General Assembly were to add additional earnings limitation exemptions for retirees participating in a phased retirement system, only employees who have reached age 62 and who are otherwise eligible for normal service retirement would be permitted to take advantage of such a program.

ALTERNATIVE TO PHASED RETIREMENT

An alternative to implementing a phased retirement program is to place renewed emphasis on workforce and succession planning within State government. The goal of workforce and succession planning is very similar to that of a phased retirement program. In both cases, the employer is attempting to address future skills and knowledge gaps by identifying and anticipating these gaps and performing a variety of knowledge transfer and training activities. Workforce and succession planning permits forecasting tailored to individual agency needs.

Agencies having positions that are organization-specific, require highly specialized skill sets, or have longer learning curves may benefit from succession planning activities. Where phased retirement typically pairs an exiting employee with a successor employee, succession planning builds a "bench" of talent. In the long run, this benefits employees as a whole, as well as the agency.

Succession planning focuses on identifying key leadership positions within the department and taking steps necessary to develop employees to assume the reigns as positions are vacated. The focus is on positions having a critical role within the department and establishing a plan to fill these positions as employees exit the organization. Although these positions may not be key leadership positions, it is appropriate to include them in succession planning efforts if the position has a significant impact on the achievement of the department's mission and strategic goals and objectives. These key leadership and critical roles are the "key positions" on which succession planning efforts are focused.

A position should be considered key if it is a significant contributor in achieving the department's mission; it performs a critical task that left undone would hinder the department's ability to perform vital functions; or, it requires specialized or unique expertise that would be difficult to replace if the incumbent vacated the position.

Once agency key positions have been identified, the essential functions and core competencies that are necessary for success in the position must be identified. Core competencies include things like flexibility, communications skills, managing conflict, customer focus and the like. It also is important to determine if there are educational or experiential needs, and specialized skill sets that might be needed to be successful in a key position.

In order to effectively develop succession plans to fit agency needs, it is necessary to perform gap analysis to determine whether and how many qualified or potentially qualified internal candidates are present within the organization. In this way, succession planning is more inclusive than phased retirement, which typically pairs a senior employee with a chosen successor. Succession planning assesses bench strength more globally. Within the State's merit system framework, a succession planning model is the better tool for establishing a pool of talent that provides employees with equal opportunity for training, development and promotions.

FINAL RECOMMENDATION

Even if the General Assembly were to amend the statute to eliminate the barriers in Maryland's law, federal requirements would limit the scope of the program to only employees who have reached age 62 and who are otherwise eligible for normal service retirement. As a result, we believe that the State would receive very limited benefit from such a program while having to invest significant resources in changing the statute and managing the program. In short, we don't believe that the return on a phased retirement program is enough to warrant the resource investment in changing the statute and administering the program.

We do however believe that a more advantageous option is to invest resources in a renewed emphasis on workforce and succession planning. Ongoing workforce and succession planning will permit State agencies to ensure the right mix of talent exists to fulfill the needs of agencies now and in the future. It is a collaborative process that engages employees and does not simply target individuals who reached a certain age. It is a more flexible approach than phased retirement, given the way in which a phased retirement program would have to be structured and restricted because of legal limitations.

Succession planning, in particular, places more emphasis on looking with a critical eye at a department's internal resources. The process of succession planning involves identifying and developing current employees with the potential to fill key leadership positions, identifying competency gaps, and developing the strategies that are necessary to address these gaps. It is an inclusive process and offers more professional growth opportunities over the long term to a larger number of employees. For all of these reasons, we recommend a renewed emphasis on workforce and succession planning. This is a reasonable alternative to a phased retirement program that suffers from legal limitations.