

Department of Legislative Services
Maryland General Assembly
2004 Session

FISCAL AND POLICY NOTE

House Bill 476
Appropriations

(Delegate Fulton)

**Employees' Retirement System and Employees' Pension System - (Comeback
Early Out) Deferred Retirement Option Program**

This pension bill creates a “comeback early out” deferred retirement option program (DROP) for certain members of the Employees’ Retirement System (ERS) and Employees’ Pension System (EPS). It provides for pension benefit calculation enhancements under specified circumstances with corresponding reductions in salaries for these members.

The bill is effective June 1, 2004.

Fiscal Summary

State Effect: The State’s actuary advises that the bill would significantly increase pension liabilities with resulting increases in employer pension contributions. The State Retirement Agency (SRA) indicates that this bill could disqualify the State Retirement and Pension System (SRPS) plans from its Internal Revenue Service (IRS) tax-exempt status. Employee salary savings cannot be reliably estimated at this time and would depend on program participation. Special fund expenditures could increase by \$602,000 in SRA in FY 2005 due to one-time information technology and ongoing administrative costs to create the program. Out-year expenditures reflect inflation.

Local Effect: None.

Small Business Effect: None.

Analysis

Bill Summary: The major provisions of the bill are:

- members of ERS or EPS with more than 25 and less than 35 years of eligibility service are eligible to participate;
- the employee election must occur between July 1, 2004 and December 30, 2004;
- members may participate in a DROP for a period not less than the greater of:
 - three years;
 - for a member with less than 30 years of eligibility service, the difference between 30 years and the member's eligibility service as of the date of the member's election to participate in DROP and retire from the employees' retirement or pension system; or
 - a term agreed to by the member and the Secretary or the Secretary's designee of the department for which the member works.
- for members with less than 30 years of eligibility or creditable service, additional eligibility and/or creditable service is granted to equal 30 years;
- retirement benefits are calculated on 30 years of service for members with between 25 and 30 years of credit who participate and on actual credit for participants with more than 30 years;
- individuals who elect to participate will receive a general salary increase of 10% for employees with less than 30 years of eligibility service and 15% for employees with 30 or more years;
- retirement benefits are calculated using average final compensation (AFC) that reflects actuarial assumptions of what the member's AFC would be at the termination of the DROP period;
- the participant's retirement allowance would be paid directly to the participant;

- the participants' annual compensation would be reduced by the amount of the annual retirement allowance so that the compensation and pension in total are not greater than the prior annual salary rate;
- if a participant who entered the program with less than 30 years of service shortens the agreed DROP period either by altering the original termination date or by being terminated from employment, the member's retirement benefits are recalculated based on actual service but are not reduced based on the over-projected AFC;
- any increase to the accrued liabilities resulting from this legislation is to be funded over 15 years, beginning July 1, 2005; and
- the Department of Budget and Management must report any budget savings resulting from participation in this DROP (potential savings on employer contributions and salary), and revert those savings to the general fund.

Current Law: There are no provisions in current law that permit members of any retirement system to simultaneously collect a retirement benefit and a salary for the same position.

Background: Members of the State Police Retirement System and the Law Enforcement Officers Pension System have DROP programs. Under DROP, a member elects to technically "retire" but agrees to work for no more than a fixed additional period of service. The member's benefit payments are deferred into an interest-bearing account held by SRA. When the DROP period ends and "true" retirement begins, the retiree receives a monthly retirement benefit based on the years of service and salary at the time they entered DROP, plus a lump sum payment equal to the value of the DROP account. Both the State Police and the Law Enforcement Officers' DROP legislation required a favorable IRS private letter ruling before those programs became effective in order to ensure that the tax qualified status of the State's defined benefit plan was not jeopardized.

Chapter 353 of 1996 provided for an early retirement incentive program. The statute established an early retirement incentive plan for State employee members of ERS and EPS. Members were eligible to participate if they were eligible to retire on the effective date of the Act or had at least: (1) 25 years of service and are age 50 or over; or (2) 20 years of service and whose positions were abolished before June 30, 1997. Participants received one month of additional service credit for each year of creditable service and had up to 18% (three years) of the reduction for early retirement eliminated. The Act provided that any increased actuarial liability be amortized over five years beginning in fiscal 1998. This amortization schedule meant that the costs of the program were being

paid off in roughly the same period of time in which the State received the benefits of salary reductions.

State Fiscal Effect:

IRS Tax-Deferred Status Disqualification

It is likely that this bill, as drafted, would compromise the plan's IRS tax-qualified status by permitting participants to receive their salaries and retirement benefits simultaneously. SRA's legal staff advises that the effects of losing tax-qualified status as a defined benefits plan could include the following:

- employer contributions made on behalf of all members of the disqualified plans (\$608.3 million total in fiscal 2003 and \$118.8 million for the employees' systems in fiscal 2005) would be treated as taxable income to the employee;
- employee contributions (\$208.1 million total in fiscal 2003 and approximately \$60 million for the employees' systems in fiscal 2005) made on behalf of the employee through the State Pickup program would be treated as taxable income to the employee for federal income tax purposes (employee contributions are already taxable income in Maryland);
- loss of favorable tax status on some lump-sum distributions from disqualified plans (or at least the portion of the benefit accrued after the plans lost their tax-deferred status); and
- monetary sanctions on the plans.

The agency notes that the system itself could also lose tax-qualified status which may result in the system having to pay income taxes on all investment income. For fiscal 2003, the systems earned \$187.1 million in investment income.

Pension Actuarial Impact

The State's actuary has informally reviewed this bill and estimates that the program could add significant liabilities to the system. Pension benefits for participants would be significantly enhanced. AFC would be increased by 10-15%, plus 4% per year based on actuarial assumptions during the proposed DROP period (which is significantly higher salary growth than is actually projected during the next five years). Creditable service would be increased by up to five years. Early retirement reductions for members with

less than 30 years would be eliminated by granting additional eligibility service to bring these members up to 30 years.

Every member with 30-35 years of service could (1) join the program; (2) receive the enhanced benefit; (3) immediately retire and separate from State service, and (4) continue to receive the enhanced benefit. There are no penalty provisions for early withdrawal from the program for members who enter the program with 30-35 years of eligibility service.

State Retirement Agency Administrative Costs

SRA estimates that administrative costs to implement and administer the provisions of this bill would total \$602,002. This estimate includes substantial computer programming for the agency's 30-year-old legacy benefit administration system and additional staff resources for implementation of the bill. The following is a detailed estimate of agency expenses that would be required to develop and implement the provisions of this bill.



State Retirement Agency Cost Estimate
Implementation of Comeback Early Out Program

Communication Materials	\$6,000
Mailing (estimates, information to membership)	6,410
DROP Seminars for Members (100 meetings)	8,092
Ongoing Member Communications and Counseling Costs	\$20,502
State and Contractual Programmer Analysts	\$350,000
Supplies for Contractual Employees	1,500
Data Processing and Testing	225,000
Additional CPU Processing	5,000
Start-up Information Technology Costs	\$581,500
Total First Year Cost	\$602,002

Source: State Retirement Agency



Budgetary Savings Impact

The Department of Legislative Services is unable to provide a reliable estimate of budgetary savings. SRA notes that up to 17,236 members would be eligible to participate on the July 1, 2004 effective date. Based on the alternative pension enhancements, it is likely that the participation rate would exceed 95%. Once the enhanced benefit is

calculated, the salary that participants receive is reduced by the value of the retirement benefit. To the extent that members participate, agencies would realize short-term budgetary savings equal to the aggregate pension reduction applied to participants' salaries. Any such agency budget savings would be for fiscal 2005 only; after that agencies would be subject to a pension liability surcharge in addition to their standard employer pension contributions.

Additional Information

Prior Introductions: None.

Cross File: SB 145 (Senator McFadden) (By Request) – Budget and Taxation.

Information Source(s): Milliman USA, State Retirement Agency, Department of Budget and Management, Department of Legislative Services

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Analysis by: Daniel P. Tompkins

Direct Inquiries to:
(410) 946-5510
(301) 970-5510