SB 688

Department of Legislative Services

Maryland General Assembly
2004 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 688 (Senator Hogan)
Budget and Taxation Appropriations

State Employees - Unused Annual Leave - Special Pay Plan

This bill requires certain State employees to deposit the value of any annual leave remaining at the time of separation from State service into a special pay plan (SPP). The bill provides for the implementation of the SPP and the selection of a third-party administrator.

The bill is effective July 1, 2005.

Fiscal Summary

State Effect: General fund expenditures could increase by $301,300 for one-time expenses in FY 2006 to implement SPP. In addition, general or special fund expenditures could increase in FY 2006 for ongoing administrative expenses dependent on which agency is designated by the Secretary of Budget and Management to implement SPP. Future year expenditures reflect annualization and inflation. Also, depending on participation in the program, general and special fund expenditures could decrease in FY 2005 due to reduced personnel expenditures (all funds) for federal payroll taxes offset by reduced payment of State income taxes.

(in dollars)	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
GF Revenue	$0	(-)	(-)	(-)	(-)
GF Expenditure	0	101,300	-	-	-
SF Expenditure	0	100,000	0	0	0
GF/SF Exp.	0	-	-	-	-
Higher Ed Exp.	0	100,000	0	0	0
Net Effect	$0	($301,300)	$0	$0	$0

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Reduction in local income tax revenue, depending on participation in the program.

Small Business Effect: None.

Analysis

Bill Summary: The bill requires the Secretary of Budget and Management (the Secretary) or the Secretary's designee to create a SPP. A SPP is a deferred compensation plan organized under section 401(a) of the Internal Revenue Code (IRC) that allows the State to transfer the cash value of employees' unused annual leave at the time of separation from service into a tax-deferred account on behalf of the employee. The employee would be able to manage the investment of the funds with SPP's third-party administrator, take the cash value of the unused annual leave, or roll over the unused annual leave to another qualified tax-deferred plan.

The Secretary is required to implement and maintain SPP, including adopting regulations to carry out the provisions of the bill. The Secretary is required to solicit for a "designated company" to administer SPP. The bill specifies that the designated company must be authorized to offer a SPP by the Internal Revenue Service. The Secretary may designate any unit of State government to oversee SPP. If the Secretary designates another unit of State government, the Secretary must notify the Senate Budget and Taxation and the House Appropriations committees of the designated unit in writing within 30 calendar days.

The bill requires the Secretary to adopt regulations that establish the criteria for eligible participants. Eligible State employees are required to participate. The Comptroller is required, on behalf of the eligible employee, to contribute into SPP (1) unused annual leave; and (2) any other compensation approved by the Secretary. Participating employees are immediately 100% vested.

The bill specifies that the Secretary or their designee is not responsible for (1) retirement counseling with respect to SPP; (2) preparing or disseminating information with respect to the provisions of SPP offered by a designated company; or (3) enrolling, terminating, or retiring a participating employee. The designated company is required to provide participating employees with specified information and provide and pay for all administrative, informational, and counseling services with respect to SPP.

Current Law: State employees may receive any unused annual leave as a lump-sum payment in their final payroll transaction from the Central Payroll Bureau, the Maryland Department of Transportation (MDOT) payroll system, or the University System of Maryland (USM) payroll system. The lump-sum is determined by multiplying one-tenth the employee's bi-weekly salary times the number of days of unused annual leave that were accrued at the end of the previous calendar year and current year annual leave that remains unused at the time of separation. Employees terminated for moral turpitude and those terminated within six months of appointment are not eligible for payment of unused annual leave.

Employees are authorized to place any payments into qualified tax-deferred accounts at the time of separation. However, because the payments are made to the employee, they are subject to federal, State, and local taxation. These contributions are also subject to applicable federal maximum deferral amounts. Contribution limits for 2004 are up to 100% of earned compensation, or $13,000. When participating in both the 457 plan and the 401(k) plan (or 403(b) plan), one may contribute $13,000 a year to each plan for a potential combined contribution of $26,000.

Background: The Department of Legislative Services (DLS) advises that under the provisions of this bill, participating employees would have three options. Employees could (1) leave any money in SPP until they are eligible to receive qualified distributions from the fund (age 55); (2) roll over the SPP account into a deferred compensation plan with another provider (deferred compensation plans with the Maryland Supplemental Retirement Plans (MSRP) or another private investment firm, etc.) as a trustee-to-trustee transfer and still receive tax deferral on the amount until distributions are made; or (3) take a distribution immediately from the designated company for the lump sum. Under the third option, the designated company would withhold 20% of the value of the distribution for tax purposes, but the employee would still not be required to pay Social Security or Medicare taxes on the distribution.

Exhibit 1 provides a comparison of the payment of unused annual leave to the employee in a lump-sum cash distribution versus participation in a SPP. The employee and employer would each save the 7.65% federal payroll taxes for Social Security and Medicare (FICA). The employee would also defer payment of federal, State, and local taxes until distributions are made from the SPP account.

Exhibit 1
Tax Implications of Lump-Sum Distributions vs. SPP
Net Employee Payment

	Lump-Sum Distribution	SPP
Cash Value of Unused Annual Leave	$10,000	$10,000
Federal Payroll Taxes (7.65%)	765	-
Federal Income Tax Withholding (28%)	2,800	Tax Deferred
State and Local Income Tax (4.75% State – 2.9% Local)	765	Tax Deferred
Net Payment to Employee	**$5,670**	**$10,000**

MSRP has the responsibility of administering the State's: (1) Deferred Compensation Program operated pursuant to IRC Section 457; (2) Tax-Deferred Annuity Program for Educational Employees under IRC Section 403(b); (3) Savings and Investment Program under IRC Section 401(k); and (4) Employer Matching Plan operated under IRC Section 401(a).

State Fiscal Effect:

Tax Impact

State general and special fund personnel expenditures would decrease due to reduced payment of FICA taxes on cash distributions of the value of unused annual leave, but State general fund revenues would decrease due to lost income tax revenue on the cash distributions.

The Department of Budget and Management (DBM) began tracking the total value of unused annual leave paid to State employees in 2003. For fiscal 2003, the State paid approximately $17.0 million (State, MDOT, and USM payroll systems). DBM reports that of that total, $10.8 million as paid to 2,433 employees from the State and MDOT systems; the remainder was to higher education employees. The Comptroller advises that MDOT and USM may not be able to complete required payroll system programming changes in time and that some employees may alter retirement plans to retire early and receive their cash disbursement rather than enter the mandatory SPP.

DLS advises that the exact amount of unused annual leave in SPP would depend on the eligibility criteria for participation developed by DBM and the amount of unused annual leave that would have been paid out in a particular year. The State income tax of 4.75% and average local rate of 2.9% essentially match the reduced payroll tax rate of 7.65%. Due to these rates, DLS advises that the total State and local revenue loss from income tax withholding would approximately equal the reduction in FICA expenditures. DLS further advises that some portion of this lost revenue may be recovered in future years as distributions from SPP accounts are made but only if the participant still resides in, and pays taxes to, Maryland.

Administrative Cost Impact

DLS estimates that MSRP has sufficient excess administrative capacity to absorb the administrative responsibilities of SPP. If the Secretary designates MSRP as the coordinating and oversight unit for SPP, State administrative costs could be handled within existing resources. MSRP is funded through an annual assessment on the asset value of participant accounts. Any administrative costs absorbed by MSRP to oversee SPP over and above the existing excess capacity at MSRP would be paid by participants in the State's existing deferred compensation plans. DLS estimates that there should be no increase in fees assessed by MSRP related to the provisions of this bill.

If the Secretary designates any other agency as the oversight unit for SPP, DLS estimates that an additional three positions would be required to implement and maintain SPP including monitoring the designated company and oversight of the program. State expenditures could increase by an estimated $164,597 in fiscal 2006, which accounts for the bill's July 1, 2005 effective date. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Salaries and Fringe Benefits	$149,194
Operating Expenses	15,403
Total FY 2006 State Expenditures	**$164,597**

Future year expenditures reflect: (1) full salaries with 4.6% annual increases and 3% employee turnover; (2) 1% annual increases in ongoing operating expenses; and (3) removal of one-time programming costs.

Implementation Cost Impact

The Comptroller also estimates $101,300 in one-time programming costs in the Central Payroll Bureau to facilitate the electronic transfer of funds to the designated company.

MDOT has indicated a similar level of programming costs would be required for its payroll system. The Comptroller advises that USM is currently undergoing an upgrade of its payroll system, and that SPP could add to the cost of that upgrade. DLS estimates that total additional program costs for the three payroll systems to be integrated with the designated company for electronic transfers of funds could total $301,300 in fiscal 2006.

Local Revenues: Annualized revenue reductions, beginning in fiscal 2006, could be $493,000. DLS advises that some portion of this lost revenue may be recovered in future years as distributions from SPP accounts are made but only if the participant still resides in, and pays taxes to, a Maryland jurisdiction.

Additional Information

Prior Introductions: None.

Cross File: HB 1339 (Delegate Madaleno) – Appropriations.

Information Source(s): Milliman USA, Comptroller's Office, Maryland Supplemental Retirement Plans, State Retirement Agency, Department of Budget and Management, AIG VALIC, Department of Legislative Services

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