Department of Legislative Services

Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE

Senate Bill 583 (Senator Kasemeyer) (Chairman, Joint Committee on Pensions)
Budget and Taxation Appropriations

State Employees - Special Pay Plans

This bill extends the implementation date for the Special Pay Plan by one year, to July 1, 2006. The bill also requires that the Maryland Supplemental Retirement Plan report to the Joint Committee on Pensions by December 31, 2005 on the following: (1) the issue of eligibility to participate in the Special Pay Plan, given that participation is mandatory; (2) the issue of oversight and administration of the Special Pay Plan, including whether the Board of Trustees for the Maryland Teachers' and State Employees' Supplemental Retirement Plans should be provided with the primary oversight and administrative authority; (3) the issue of implementing the Special Pay Plan for three separate payroll systems within the State, including the Central Payroll Bureau, the Maryland Department of Transportation payroll system, and the University System of Maryland payroll system; and (4) the results of a request to the Internal Revenue Service for an official ruling on the validity of the Special Pay Plan.

The bill is effective July 1, 2005.

Fiscal Summary

State Effect: The bill's requirements could be handled with existing resources.

Local Effect: None.

Small Business Effect: None.

Analysis

Current Law: State employees who are separated from employment with the State may receive any unused annual leave as a lump-sum payment in their final payroll transaction. The lump-sum is determined by multiplying one-tenth the employee's biweekly salary times the number of days of unused annual leave that remain at the time of separation. The lump-sum payments to the employee may be placed into a qualified tax-deferred retirement account at the time of separation; however, the payment is subject to the applicable federal maximum deferral amounts ($13,000 in 2004).

Chapter 302 of 2004 authorizes the Secretary of Budget and Management to establish a Special Pay Plan for State employees under § 401(a) of the Internal Revenue Code. The legislation is effective July 1, 2005.

Background: The Joint Committee on Pension studied SPP in the 2004 interim and issued a report. Placement of lump-sum payments by the State for unused annual leave into a Special Pay Plan under § 401(a) of the Internal Revenue Code alters the taxation of the payment. The payment is no longer considered salaried compensation and is accorded the same benefits as retirement contributions made by employers to other tax-deferred retirement plans. As a result, there can be advantageous tax consequences for both the State as the employer and the employee. Under § 401(a), any funds placed in the Special Pay Plan are not subject to the 6.2% FICA tax or the 1.45% Medicare tax. Consequently, the State and the employee each save a total of 7.65% in FICA and Medicare taxes. Similar to a § 401(k) plan, funds deposited into the Special Pay Plan would also be income-tax-deferred until withdrawn.

To qualify as a Special Pay Plan under § 401(a) of the Internal Revenue Code (IRC), the plan cannot permit eligible employees to choose whether or not to place unused annual leave payments into the Special Pay Plan. Similarly, the contribution by the State of the unused annual leave payment into the Special Pay Plan is a nonelective contribution.

Once the funds are placed into the Special Pay Plan, they are treated in the same manner as other qualified tax-deferred retirement plans. As is the case with other qualified plans, if an employee is under the age of 55, the employee will be subject to a 10% early cash withdrawal penalty for withdrawal of monies from the Special Pay Plan. The employee may avoid the penalty by agreeing to a disbursement plan that provides an equal annual distribution of the funds until age 59½. If a lump-sum is distributed from the plan to any employee regardless of age, it will be subject to mandatory income tax withholding at the 20% rate. All employees with funds in the plan will also have the option to roll funds over into another qualified defined contribution plan such as a 403(b) or 457 or IRA plan.

The report also found that, before the implementation of the plans could begin, significant questions remained related to eligibility for the plan, implementation of the plan, the appropriate entity to administer the plan, and oversight of the private company selected to administer the plan.

Additional Information

Prior Introductions: HB 1339 of 2004 was enacted as Chapter 302 of 2004 and established the Special Pay Plan, with a July 1, 2005 effective date.

Cross File: None.

Information Source(s): Maryland Supplemental Retirement Plans, Department of Budget and Management, Department of Legislative Services

Fiscal Note History: First Reader - February 22, 2005
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