MARYLAND STATE RETIREMENT AND PENSION SYSTEM

REEMPLOYMENT OF RETIRED MEMBERS - FEDERAL TAX ISSUES

There are two key tax issues related to the reemployment of individuals by the State or participating governmental units who are retirees of the Maryland State Retirement and Pension System: (1) the tax qualification of the plans under the Maryland State Retirement and Pension System; and (2) the possibility of the imposition of the 10% early distribution tax on benefits received by retirees. The following information is provided in order that State and participating employers may better understand the rules.

1. **PLAN QUALIFICATION** – A defined benefit retirement plan, such as the plans under the Maryland State Retirement and Pension Plan, must meet many requirements under the Internal Revenue Code in order to be a "qualified plan" under the Code and receive certain important tax advantages. One of those requirements provides that, in general, a member may not withdraw contributions made by the employer, or earnings on such contributions, before normal retirement, termination of employment, or termination of the plan. Rev. Rul. 74-254, 1974-1 C.B. 94. "Normal retirement age cannot be earlier than the earliest age that is reasonably representative of a typical retirement age for the covered workforce." Prop. Treas. Reg. Sec. 1.401(a) – 1(b)(1)(i). A retirement age that is lower than 65 is permissible for a governmental plan if it reflects when employees typically retire and is not a subterfuge for permitting in-service distributions. PLR 200420030.

Therefore, as a matter of plan qualification, retirement benefits may be paid to an employee who reaches "normal retirement age" once the employee retires and separates from service, and the reemployment of such a retiree by the same employer should not raise concerns regarding plan qualification. For example, the reemployment of a member of EPS, after the member retires at the age of 62 (the normal retirement age) or later, or the reemployment of a member of the State Police Retirement System, after the member retires at the age of 50 (the normal retirement age) or later, should not raise **plan qualification issues**, regardless of the circumstances regarding the reemployment. Conversely, the reemployment of a member of EPS who has retired prior to the age of 62, or the reemployment of a member of the State Police Plan who has retired prior to the age of 50, by the same employer, may raise plan qualification issues. In order to avoid such concerns, the plan must be able to show that, in such circumstances, employment has been terminated.

Of course, regardless of whether the individual has reached "normal retirement age" and retired, in some instances of reemployment there are various restrictions that will still apply pursuant to state law, such as earnings limitations and the 45-day break in service.

Even if an individual is exempt from the state earnings limitations, that does not exempt the individual, or the System, from any of the federal tax law requirements discussed in this memorandum.

In addition, please be aware that some employers and employees believe that a retiree may be brought back under the title of an "independent contractor" without violating rules requiring a separation from service. These relationships must be closely analyzed so that someone who is actually an employee is not mischaracterized as an independent contractor. The IRS has a 20-factor test to determine this status, which should be considered in these cases. In general, the IRS is looking at whether the employer exercises or retains the right to exercise direction and control of the "independent contractor" in the same manner as the employer exercises control over an employee. Rev. Rul. 69-647, 1969-2 C.B. 100.

2. **TAX PENALTIES** – As a separate matter from plan qualification, the Internal Revenue Code, Section 72(t), imposes an additional 10% premature distribution tax on the recipient of retirement benefits when those benefits are paid to members prior to the date the member attains age 59 ½ unless some exception applies. The key exceptions are as follows:

- payments after the member's death;
- payments attributable to the member's disability;
- payments (lump sum or otherwise) to a member after age 55 who has **separated from service**;
- substantially equal periodic payments (at any age) commencing after the member **separates from service** and payable over the member's life or the joint life of the member and member's beneficiary.

Two of the key exceptions to imposition of the tax penalty, the age 55 exception and the substantially equal periodic payments exception, require a "separation from service." Therefore, regardless of the "normal retirement age" of the plan in which the employee is a member, if the member receiving benefits is under the age of 59 ½ , in order to avoid being subject to the 10% early distribution tax, the member must be able to demonstrate that s/he has "separated from service."

There is no "normal retirement age" exception that applies to the 10% early distribution tax. Conversely, the 59 ½ exception under the tax penalty law does not apply to the issue regarding the tax qualification of the State's retirement and pension plans.

3. **SEPARATION FROM SERVICE** – To assure both plan qualification and avoidance of tax penalties, in any situation in which (a) the employee has not reached normal retirement age and has not reached age 59 ½ , (b) the employee retires and begins receiving benefits, and (c) the retiree is reemployed with the same employer (all state entities are considered to be the same employer) and continues to receive retirement benefits, the focus will be on whether there has been a bona fide separation from service**.** Neither the Internal Revenue Code or regulations define "separation from service" and the meaning must be derived from a variety of cases, Revenue Rulings, and Information Letters.

Based on those cases and rulings, the following factual circumstances most likely **will not** constitute a "separation from employment" without a significant break in employment:

(a) No change in services rendered; or
(b) A reduction in work schedule.

Based on those cases and rulings, the following factual circumstances most likely **will be** considered a bona fide "separation from employment:"

(a) The employer no longer exercises or retains the right to exercise the direction and control necessary under the common law rules to maintain the employer-employee relationship;
(b) At the time of retirement, the employee has no intention of returning to work and there is no arrangement for reemployment between the employee and employer, and there is a significant break in time between when the employee retires and is rehired.

In a 2011 Private Letter Ruling, the IRS stated that "if both the employer and employee know at the time of 'retirement' that the employee will, with reasonable certainty, continue to perform services for the employer, a termination of employment has not occurred upon 'retirement,' and the employee has not legitimately retired."

However, because there is no statutory provision and the IRS has issued no regulations regarding what constitutes a "separation from service," it is not

possible to provide any more definitive advice. The bottom line is that, when members retire from any plans within the Maryland State Retirement and Pension System, and the member is either younger than the "normal retirement age" for that plan or the member is under the age of 59 ½, it must be a bona fide retirement. In other words, the member should intend to permanently retire from employment with the State of Maryland. Retirement should not be conditioned upon offers of reemployment, and, in fact, no offers of reemployment should be made or discussed by the employer at the time of retirement.

The more differences there are between the last job before retirement and job being performed when the person is rehired, and the longer the break between the date of retirement and the date of rehire, the more likely it is that there is a bona fide retirement, and, therefore, a "separation from employment."

That part of the Retirement Application in which the employer certifies the retiree's last day on payroll is the **employer's certification** that the employee has "separated from employment," and the certification is relied upon by the Maryland State Retirement and Pension System in paying retirement benefits.

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