ELECTIVE DEFERRALS - SEVERANCE PAY

Elective deferrals are permitted to be taken from ongoing salaries during employment, *and under the final 415(c) regulations*, from certain kinds of severance pay (unused sick leave, or vacation pay, or from *bonus pay that would have been paid even if the employee had not left employment) **as long as that severance pay is paid by the end of the calendar year or if later, within 2 ½ months after severance of employment**.

Elective deferrals *cannot* be made from early retirement incentive pay or amounts paid to buy out contracts unless the payroll period in which those amounts are paid begins while the employee is still employed. The sections of the final regulations that deal with salary reduction contributions from severance pay are
given a retroactive effective date of January 1, 2005, and *can be relied upon.* As long as salary reduction agreements are executed for the **elective deferrals** prior to the time the severance pay has been made available to the employee, the deferrals are now clearly permissible under the new rules. However, it is important that an individual planning to make those contributions after employment has established the 403(b) account *before employment actually ceases.*

**such as a bonus for job performance*

POST RETIREMENT EMPLOYER CONTIBUTIONS TO 403(b) PLANS

EGTRRA codifies the ability of an employer to make **employer contributions to a 403(b) plan for a full five years following the year of the employees' severance from employment** with the current employer in Section 403(b)(3). Effective on January 1, 2002, the contributions are permitted based on 100% of the departed employee's includible compensation in the last full year of service before retirement, subject to the dollar limit of Section 415(c) ($51,000 in 2013) per year for each of the five years after retirement. This represents a significant opportunity for years after 2001 specifically for public education institutions and any other governmental employer that is also a 501(c)(3) organization. (Post retirement contributions made by 501(c)(3) organizations are also permitted. However, keep in mind that nondiscrimination rules and ERISA coverage will apply to them; thus, the post-retirement contribution plan must be carefully constructed to meet those requirements.)

The **final 403(b) regulations**, for the first time, provide guidance on whether contributions can continue to be made to a specific participant **should that participant die** before all of the promised contributions have been made. Unfortunately, those final regulations (effective on January 1, 2009) specifically **prohibit contributions after the month of the participant's death**. **However, it is important to note that those contributions in the month of the participant's death can be accelerated to the full possible maximum ($51,000 under Section 415(c) in 2013, as indexed), often making it possible to fulfill the full obligation in the month of death (**subject to the contribution limits**).**

HOW WILL 403(b) CONTRIBUTIONS POST RETIREMENT BE CALCULATED?

The IRC 403(b)(3) definition of includible compensation (SEE BELOW) has been retained in EGTRRA specifically to make post retirement contributions permissible. That definition will permit the use of the retiring employee's compensation in the final period that counts as one full twelve-month period of service. Thus, the contributions made for each of the five years will be calculated as follows:

1. Includible compensation for last 12-month period of service times 100% (SEE BELOW),
2. Capped at the dollar limit under Section 415(c) for that year ($51,000 in 2013, indexed in $1,000 increments). Quite simply, any employee who has more than the dollar limit in includible compensation in the final 12-month period of service will be eligible to receive a contribution of that amount for *each* of the five years after the year of retirement.

KEY EMPLOYER POINTS - HOW PUBLIC EDUCATION EMPLOYERS WILL SOLVE PROBLEMS WITH POST RETIREMENT CONTRIBUTIONS:

Early Retirement Programs: Many employers are seeking ways to entice long-term higher paid employees to retire early, so that those employees can be replaced with new lower-paid employees in an effort to reduce salary expenses, the single most expensive item in the budget.

Replace More Expensive Unused Sick Leave & Vacation Pay: Remember that **employer contributions to a 403(b) plan <u>are not</u>** subject to:

- payroll taxes or
- fringe benefit payments

Compensation is subject to payroll taxes and fringe benefit payments. Additionally, many school districts are increasingly concerned about the large amounts of unused sick leave pay or vacation pay that must be paid at the time employees retire. **Post retirement contributions can be** used to:

- replace those more expensive payouts
- stretch the cost of making those payments over as much as 5 years.

Generally, employees will prefer not to receive large sums for unused sick leave or vacation pay "all at once" because of the income tax consequences. Instead, many will prefer receiving those amounts as contributions to their 403(b) plans for up to five years after retirement.

Problems faced by Public School District: Public school districts routinely pay all unused sick leave/unused vacation and other types of severance pay to employees; however, recently it has had employee resistance to the income tax consequences of what are often large checks**. District has also found it increasingly difficult to have enough money available in the budget to pay unused sick leave and vacation pay, especially in years when there are a large number of retirees**. District has considered paying the unused sick leave and vacation pay over more than one income tax year to ease the budget burden, and to make it more palatable to employees;

however, does not want to incur the administrative burden of tracking post retirement compensation.

Additionally, deferring compensation to later years may cause the entire amount to be taxable immediately.

Solution: You can explain to District that employer contributions to a 403(b) plan can be made for a full five years following retirement to a maximum of $51,000 each year (subject to the employee receiving compensation for the last full 12 months of service prior to retirement of at least $51,000). Remember, too, that dollar amount will increase due to indexing in $1,000 increments; thus, the employer contributions can increase as the limit increases.

This will accomplish tax-deferral for the employee, and budget reductions for District. Because contributions can be made at the rate of 100% of includible compensation capped at the limit of $51,000 (2013 limit, indexed in $1,000 increments) a significant amount of the unused sick leave and unused vacation pay can, indeed, be made as an employer contribution. Note the following important points:

1. To implement a post retirement 403(b) plan, it will be vital that you remind the employer to have legal counsel check state and local law, as well as union negotiated agreements. Union agreements may need to be renegotiated to accommodate the payment of employer contributions in lieu of already earned unused sick leave or vacation pay. Also, be sure to discuss with the involved individuals the fact that contributions must cease in the month the recipient of those contributions dies – no continued payments can be made to beneficiaries should death occur before all of the promised contributions have been made.

2. Because there may be certain retiring employees who have earned limited unused sick leave, vacation, or severance pay, the plan could be structured to permit those limited amounts to be paid as compensation. For example, the plan could specify that "all employees who have accumulated more than $10,000 in unused sick leave or vacation pay will receive those amounts as post retirement contributions to a 403(b) plan over a period of five years commencing in the first calendar year following the calendar year of retirement; all others will receive those amounts as compensation in the final year of service". As long as no *individual* is given a choice to elect cash instead of the employer contribution, the employer's decision to establish specific criteria for cash payments should satisfy the requirements.

3. Be sure, too, that the employer, when establishing the employer contributions, understands that the written plan must include the optional feature of employer contributions.

INCLUDIBLE COMPENSATION FOR 403(b) CONTRIBUTIONS

The following chart recaps what is and what is not a part of includible compensation. The definition will continue to apply for years after 2001 for *all* contributions to a 403(b) plan. (Prior

to 2002, the definition applied for purposes of the exclusion allowance only, and the definition under 415(c) was different.)

What's Included

- Gross taxable wages paid for current income tax year or the most recent 12-month period of service that counts as a full year plus a participant's 402(g) elective deferrals and any other pre-tax contributions to an IRC 125 or IRC 457 plan.
- Sick leave or vacation pay attributable to current year of service.
- Salary, bonuses, and termination pay in certain circumstances.

What's NOT Included

- Any employer contribution (vested or non-vested) to a qualified plan or 403(b) plan of employer. 414(h) pick-up contributions, which are mandatory employee pretax contributions to the state retirement system defined benefit plan.
- Sick leave or vacation pay earned in prior years.
- Early retirement bonus not attributable to the current year of service or which is paid over more than one year of service (i.e. considered deferred compensation). Non-taxed housing allowance for ministers or clergy.

Exceptions

- For part-time employees, the compensation needs to equal a full 12 month period of service, and will include compensation for more than one tax year. For example: a ½ time employee's includible compensation = 6 months salary in prior year + 6 months salary in current year.
- If an employee is retiring, you need to include compensation for most recent period of service equivalent to a year of service.