

**STATE OF MONTANA
TEACHERS' RETIREMENT SYSTEM
1500 EAST SIXTH AVENUE
PO BOX 200139
HELENA, MONTANA 59620-0139
(406) 444-3134**

Advisory to TRS Covered Employers

Termination Pay Issues

March 1, 2001

The purpose of this advisory is to provide assistance to employers in the interpretation of the termination pay provisions and the pick-up provisions that were approved by the Internal Revenue Service in a private letter ruling ("PLR"). The determination of whether a payment may be considered termination pay from a federal law standpoint is extremely fact-specific. It is for this reason that Montana TRS will request that the employers' counsel be brought in to provide TRS with an analysis of the particular program and a legal opinion when the occasion warrants. Note: For the procedures for the pick-up, please refer to "Instructions for Pick-Up of Termination Pay Contributions" issued by Montana TRS on 01/2000. A copy may be found at: <http://www.trs.doa.state.mt.us/forms/Forms.htm>

Use of Termination Pay in the Calculation of Montana TRS Retirement Benefits

A Montana TRS member may use termination pay as follows:

- (1) The member may use the total termination pay in the calculation of Average Final Compensation (AFC). In this case, Montana TRS determines the amount of contributions that must be paid by both the member and the employer to purchase this additional benefit.
- (2) The member may use a yearly amount of termination pay (termination pay ÷ years of service) added to each of the three years used in AFC. The member and the employer must each pay the regular contribution rate on the included termination pay.

If a member makes an irrevocable election to use their gross termination pay amount in the calculation of the retirement benefit, and the employee contribution amount due is greater than the net termination pay available after social security taxes have been deducted, the employer must pickup and pay to TRS the net amount of the termination pay amount available (gross less any social security contributions withheld). The employee must personally pay the balance due subject to Section 415 of the Internal Revenue Code.

Example: An employee has irrevocably elected to use their total termination pay in the calculation of the AFC. The employee's net termination pay amount after social security taxes have deducted is equal to \$10,000, but the employee termination pay contributions are equal to \$11,000. The employer would be required to pick up and pay \$10,000 to TRS, and the employee would send \$1,000 to TRS.

Definition of Termination Pay

In order to use termination pay under these statutory provisions, it is important to understand the definition of termination pay and how Montana TRS is interpreting that definition. If a payment by the employer falls within the definition of termination pay and is not excluded by the federal law provisions, then the employee contribution for the termination pay adjustment under options (1) and (2) may be picked up by the employer and paid to TRS, if TRS procedures are followed. Pursuant to the PLR, the picked up amount is not included in the employee's gross income, but it is subject to FICA taxation. However, if the payment is excluded by federal law provisions, then the contributions may not be reported to TRS.

Montana law, 19-20-101(20)(a), MCA, defines termination pay as follows:

(a) "Termination pay" means any form of bona fide vacation leave, sick leave, severance pay, amounts provided under a window or early retirement incentive plan, or other payments contingent on the employee terminating employment.

(b) Termination pay does not include:

(i) amounts that are not wages under section 3121 of the Internal Revenue Code, determined without regard to the wage base limitation; and

(ii) amounts that are payable to a member from a plan for the deferral of compensation under section 457(f) of the Internal Revenue Code..

This section is a difficult section for employers and their counsel to interpret because it requires both state law interpretation and federal law interpretation in reaching a conclusion. Under subsection (a), state law determines all the forms of pay that could be considered as termination pay – it is the "inclusion provision." On the other hand, under subsection (b), federal law will determine what payments, which would otherwise be considered as termination pay under a purely state law analysis, will be excluded. The IRS has published guidance that Montana TRS must follow in deciding what will be excluded. These are Technical Advice Memorandum, TAM-108593-98 ("TAM") and IRS Announcement 2000-1. (We will provide these materials to employers and their counsel upon request.) Under the TAM and the

Announcement, each type of payment must be analyzed separately. Montana TRS has intensively reviewed these documents and has developed the following categories of benefits.

Category I.

Bona Fide Vacation Leave and Sick Leave Payments

Summary of Montana TRS Position. Montana TRS will treat lump sum payments of accrued vacation leave and sick leave as termination pay so long as they are paid to the member within a reasonable period following termination and retirement. Generally, sixty days will be considered reasonable period.

What Montana TRS will require. Montana TRS will require the employer's certification that the payments are bona fide vacation leave and/or sick leave payments.

Category II.

Safe Harbor for Severance Pay Programs in Existence on December 22, 1999

Unless the termination payment consists solely of the accrued value of vacation and sick leave, the employer may be required to submit documentation to the Teachers' Retirement System (and possibly the Internal Revenue Service) that the payments are Bona Fide Severance Pay Plans.

Summary of Montana TRS Position. The IRS has created a temporary safe harbor for severance pay programs in effect on 12/22/99. If a employer had a severance pay program in effect on 12/22/99, Montana TRS will treat the payments under those programs as termination pay if the following conditions are met:

- (1) The program is a broad-based plan, maintained primarily for non-highly compensated employees. For example: a program maintained only for administrators will not meet this condition.
- (2) The program is non-elective. This means that the program does not offer employees a choice between various benefits. For example, a program that offers employees a choice of cash or insurance benefits will not meet this condition.
- (3) The program was treated by the employer as a bona fide severance pay plan under Code section 457(e)(11) for years prior to 1999. This means that the employer has reported these benefits as severance pay — on a W-2 form when paid.
- (4) The program is designed to provide supplemental income for a transitional period, rather than to provide retirement income. An employer that provides a benefit

only for employees who apply for and receive TRS retirement benefits could conflict with this limit.

- (5) The program provides payments only after separation from service, including retirement.
- (6) If the termination pay is part of a series of payments, the series of payments may not exceed 5 years. (As you know, under Montana State law termination pay can include only those payments made at the time of termination and retirement).

All six safe harbor criteria must be met for these payments to fall under the Safe Harbor.

Montana TRS will consider a program that was in effect in December 22, 1999, and is amended thereafter to be covered by the Safe Harbor so long as the amendments fall within the six criteria.

It is important to note that the IRS could change these criteria and Montana TRS would have to change its interpretation accordingly.

What Montana TRS will require. If an employer has a Safe Harbor plan, Montana TRS will require the district to provide a copy of the plan and a certification with respect to satisfaction of the six criteria.

Category III. **General Severance Pay Programs**

Summary of TRS Position. If an employer has a severance pay program that was established for the first time after 12/22/99 or if a employer has a severance pay program that does not meet the six safe harbor criteria above, Montana TRS will apply the following federal standards:

1. **Limit on Amount.** Severance plan benefits, including sick and annual leave payments, may not exceed two times the member's compensation for the year preceding termination.
2. **Limit on Duration.** If the termination pay is part of a series of payments, all severance plan payments to the member must be completed within 24 months **following the member's termination.** Even though an employer may offer a plan that makes payments over a 24-month period, Montana law requires that termination pay be paid at the time of termination and retirement. Therefore, only

payments made at the time of termination are reportable to TRS as termination pay. Payments made within 60 days of termination would be considered termination pay for this purpose.

3. Purpose of Benefit. The purpose must meet one of two tests:
 - a. Severance of Employment. Severance arrangements must provide payments to employees BECAUSE employment has been terminated, not simply WHEN employment terminates. That is, benefits may be paid to retirees, so long as not directly or indirectly contingent on retirement. This means that the pay plan may not be limited to teachers who are the same age as, or older than, the earliest retirement age under Montana TRS.
 - b. Early Retirement Window. Severance Plans may also include payments made to employees who voluntarily terminate employment, most often before attainment of retirement age, as part of a window-type early retirement incentive program.

All three standards must be met. These standards require a case-by-case analysis.

What Montana TRS will require. Montana TRS will require the employer certification as to the objective criteria involved (amount and duration of benefit). As to the purpose of the benefit, Montana TRS may also require an opinion of counsel from the employer. If a district cannot meet these general standards, the only analysis remaining is whether the benefit payment is subject to a substantial risk forfeiture until paid. If it is subject to a substantial risk of forfeiture until paid, then at the time of payment TRS will treat it as termination pay.

Scenarios

To assist employers in understanding how Montana TRS will apply the above criteria and standards to employer termination pay plans, Montana TRS has provided the following scenarios as examples. However, it is important to understand that each employer's program has unique features, which must be analyzed in making the termination pay analysis:

Scenario 1: Since the beginning of the school year 1999, the employer has provided a \$10,000 lump sum payment to any teacher who left work in the school district. The school district has treated the payment for all purposes as severance pay. The payment is made within 60 days of termination and TRS receives the termination pay contribution within 90 days.

Analysis: Montana TRS would treat these benefits as termination pay under Category II. The employee contribution could be "picked up" (tax deferred) from the termination pay using the procedures found in the "Instructions for Pick-Up of

Termination Pay Contributions”.

Scenario 2: A \$12,500 lump sum benefit is available to any member who has at least 20 years of service of which at least 10 are with the school district. The member may elect to receive the benefit in the year of retirement or in the subsequent year. Alternatively, the member may elect to have the benefit applied to the employee's health insurance premium on a monthly basis.

Analysis: The payment in scenario 2 does **not** come under the safe harbor in Category II because of the elective nature of the benefit. Therefore, once the employer has responded with their analysis, Montana TRS will have to analyze whether the payment plan will meet the general standards of Category III. This is one of the instances where Montana TRS would have to obtain additional data. We would assume that the payout in question would pass the benefit amount test. We cannot determine whether it passes the duration test because it might last more than 24 months if the insurance premium option is selected, and thus it would fail that test. We would also have to inquire as to whether the purpose of the benefit fits within the standard. Unless Montana TRS received adequate support for the position that the benefit was a severance program and not a retirement program, Montana TRS would conclude that this payment was **not** termination pay.

Scenario 3. A teacher who terminates with at least 10 years of service but no more than 30 years of service receives a lump sum equal to \$100 for each year with the district prior to June 30, 1986, and \$200 for each full year of experience with the district after July 1, 1986.

Analysis: Based upon this description, this benefit should fall within safe harbor in Category II. If this were a program that did not fit within the safe harbor, we believe that it would fit within the general standards in Category III. Thus, these payments would be termination pay, subject to receipt of the school certification and counsel opinion. However, if the scenario were adopted so that it appeared to be limited to only retirees, the result would differ.

Scenario 4. A teacher terminating employment at any time is entitled to a lump sum benefit equal to 25% times unused sick leave credits times daily rate of pay.

Analysis: Montana TRS would consider this to be termination pay under Category I.

Scenario 5. A school district provides a severance benefit for administrators only, who leave employment after completion of 15 years or more.

Analysis: Montana TRS would not treat this as a safe harbor plan under Category II. The specific elements of the plan would have to be analyzed under Category III.

Scenario 6. A school district offers a two-part benefit for retiring teachers. First, if the teacher has at least 20 years of service, the teacher receives a lump sum of \$100 X years of service. Second, the district pays \$100/month to the district's insurance program on behalf of a retired teacher for a period of five years or until age 65, whichever is earlier.

Analysis: Each part must be analyzed separately. Unless the lump sum payment falls within the safe harbor, Montana TRS would conclude that it is not termination pay. With respect to the insurance payments, Montana TRS would conclude that these are **not** termination pay because they do not comply with the state law definition of termination pay.

Scenario 7. A district provides a multi-faceted payment program to those who leave employment.

- a. A payment for unused sick leave to a maximum of 150 days.
- b. A choice of cash or insurance coverage.
- c. A cash payment, which in turn limits the employee's right to elect Option 1 of the TRS termination pay options.

Analysis: Each aspect of the plan must be analyzed separately, not as one program. Montana TRS would likely conclude that the payment of sick leave is termination pay, but the other payments are **not** because there is a choice of benefits.

Concluding Remarks

As you can see from our analysis of the payout scenarios, the determination of whether a payment may be considered termination pay from a federal law standpoint is extremely fact-specific. It is for this reason that Montana TRS will request that employers' counsel be brought in to provide TRS with an analysis of the particular program and a legal opinion when the occasion warrants.

Employers should contact TRS as soon as possible if there are any questions regarding the termination benefits paid to terminating employees and not wait until the end of the school year after someone has retired to notify TRS and the retiring member.