

SEVERANCE PAY

Here are answers to some typical questions about severance pay. Income tax considerations, which unfortunately can become somewhat complicated, are discussed in section 4. It is always prudent to get specific advice for your own situation.

1. Under what circumstances may a superintendent or other administrator be paid severance pay?

Under Minnesota law your contract may provide for severance pay upon your termination from employment, no matter what the reason for that termination may be - retirement, resignation, termination for cause, expiration of your contract, a negotiated resignation or "buy-out," disability, death, or a decision of the board not to offer you another contract. The reasons for termination which trigger your entitlement to severance pay are a matter of negotiation between you and the board. The contract may provide for severance pay if you leave for any reason at all, or if you leave for only certain specified reasons (though, as discussed in section 4 below, it is preferable for tax reasons that severance pay be available in certain limited situations only. The severance pay clause must be clear on this. It is of course in your best interest to make your severance pay entitlement as broad as possible. Three examples of contract language are:

If the superintendent leaves the employment of the district for any reason, the superintendent shall be paid severance pay . . .

Upon termination of employment the superintendent shall be paid severance pay
...

If the school district decides not to offer the superintendent a subsequent contract upon the expiration of this contract, the superintendent shall be paid severance pay . . .

2. What is the limit on the amount of severance pay?

- a. If you are a "highly compensated employee" (your annual wages are more than 60% of the governor's salary and are at least 80% of the annual wages of the second highest paid employee in the district), the limit is six months' salary. Minn. Stat. § 465.722. (This limit is subject to certain narrow exceptions for persons who already had a higher amount in their contracts when this law was passed in 1993.) In the law that imposes this limitation, "severance pay" is defined to include all "benefits or compensation with a quantifiable monetary value" which are paid upon termination of employment, except payments for unused vacation, unused sick leave, and premiums for continued group insurance coverage. Therefore, if the school district is willing, you may be paid severance pay up to six months' salary plus some or all of your unused vacation plus some or all of your unused sick leave plus continued payment by the district for your group insurance coverage.

- b. If you are not a "highly compensated employee" as defined above, then the limit on your severance pay is twelve months' salary. Minn. Stat. § 465.72. This law defines "severance pay" so as to exclude payment for unused sick leave and payments for continued group insurance coverage, but it does not mention unused vacation (though this is generally

considered to be permissible). In any event, it is clear that you may be paid severance pay up to twelve months' salary plus some or all of your unused sick leave plus continued payment by the district for your group insurance coverage.

c. Again, the amount the district will pay is a matter for negotiation. It may be any amount within the above limits, and there are various ways to compute the amount - a formula based on years of service or percentage of salary, a flat dollar amount, and so forth. (It is recommended, however, that you not base it on age, because of concerns about such formulas under the age discrimination laws.) The contract language should be very specific about what is agreed upon, however, to prevent misunderstandings at a later time. Examples of contract language:

. . . in an amount equal to ten days' pay for each year of service to the district as superintendent (daily rate is the annual salary paid during the last year of employment divided by ___), plus payment of unused accumulated sick leave not to exceed 60 days.

. . . in an amount equal to one-half of the number of the superintendent's unused accumulated sick leave days times the daily rate of pay during the last year of employment (annual salary divided by ___), but not to exceed \$_____.

. . . in the amount of \$_____.

. . . in amount equal to \$_____ times the number of years of service as an employee of the district, but not to exceed \$_____.

d. If the total amount of your payment might exceed the limit of six months' pay or twelve months' pay (whichever applies) because part of the payment is for unused vacation and/or sick leave, you should specify one amount as "severance pay" and itemize the vacation and sick leave separately. For example:

. . . severance pay in an amount equal to ten days' pay for each year of service as superintendent (daily rate is the annual salary paid during the last year of employment divided by ___), and in addition thereto, payment for unused sick leave (maximum of 30 days) at the same daily rate.

3. May severance pay be paid in the event of death or disability?

Yes, and this may be done if the death or disability is the cause of your termination of employment, or if you die after your termination and before all the severance pay has been paid. Under the Minnesota laws cited above, if you die after termination of employment and some of the "severance pay" remains unpaid, the balance must be paid to your beneficiary or, if there is none, to your estate. This statute does not apply to payments for unused vacation or sick leave, however, so this should be stated in the contract. It is advisable to cover this subject in the contract language.

4. New Minnesota Legislation.

New legislation was passed during the 2002 Minnesota legislative session which would allow accrued sick, vacation or severance pay to be contributed as "employee" money to a qualified plan or to a 403(b) annuity or a section 457 plan. Under Minnesota Stat. § 356.24 subd. 11, a new "supplemental" plan would need to be established just for these contributions and it appears that the contributions would be "picked up" by the district and would not be subject to FICA tax. Such contributions would be subject to applicable IRC limits.

5. Income tax issues.

- a. Should the amount be paid all at once or deferred over a longer period?

This too is a matter of negotiation. The Minnesota laws cited above allow payments to be made on any schedule up to five years. (For reasons discussed below, however, you may want to spread them over no more than two years.) The board may want to spread out the payments to make them more palatable. Your primary concerns should be (i) the potential income tax consequences of a lump sum versus deferred payments (depending upon the type of plan involved and the constructive receipt rules) and (ii) whether you want to worry about the board living up to the agreement and making all the payments.

For payments made after December 31, 2001 under a Code Section 457(b) *eligible* deferred compensation plan sponsored by a governmental entity, income is not considered constructively received until it is actually paid to the participant or other beneficiary. Thus, the income tax is deferred until the payment is received, but the social security and medicare taxes are due at the time of the contribution into the plan. A Section 457(b) plan is a nonqualified retirement plan subject to an annual limit on contributions (\$11,000 in 2002, with an additional catch-up contribution available to those 50 or older). Assets must be held in a trust or a custodial account or annuity contract issued to the employer. School district contributions cannot exceed \$2,000/yr. and must be invested in the State Deferred Compensation Plan.

However, for payments made under a deferred compensation plan which is considered *ineligible*, also known as a Code Section 457(f) Plan, the "constructive receipt" rules apply. Under the constructive receipt doctrine, you have taxable income on the earlier of: 1) the year in which it becomes available to you, or 2) the year in which your right to the payment becomes nonforfeitable (i.e. fully vested). Under Code Section 457(f) Plans, income is "available" when it comes under the control of the recipient, whether or not the recipient chooses to take possession of it. If, therefore, you alone are entitled under your contract to decide at the time of termination whether to receive all of the severance pay immediately, or defer it over two or more years, you have constructively received all of it in the first year, and you will be taxed on all of it in the first year. This same tax treatment would apply to payments made prior to January 1, 2002 under a Code Section 457(b) Plan.

There are several ways to avoid this result. (i) If you know the payment schedule you want, you should get the agreement of the school board to that schedule now and include the schedule in your contract. Even if you're not sure of the schedule, it can be modified later by mutual agreement. (ii) You may state in the contract that the school board will decide later what the payment schedule will be. Or (iii) you may specify in the contract that the payment will be

made on a schedule that is to be mutually agreed upon by you and the school board at a later date. Any modification should be contained in a contract finalized at least two years before your termination.

Whichever option you choose, it should be specified in the contract. If your contract says nothing about a payment schedule, you will be deemed to have received all of your severance pay at the moment your employment terminates, even if the board decides upon or agrees to a deferred payment schedule.

b. Avoiding taxation of the severance pay *before* you leave employment.

The income tax laws relating to deferred compensation have changed dramatically in recent years. Section 457 of the Internal Revenue Code places limitations on the amount of deferred compensation (such as payments or annuities) that can be earned without being subject to taxation at the time the compensation is deferred.

Section 457 generally limits salary deferrals to \$11,000 a year (as of 2002), with a special provision for participants who are over age 50 which allows additional deferrals (\$1,000 in 2002, subject to annual increases). Effective January 1, 2002, these deferral limits are no longer calculated in combination with amounts deferred under a 403(b) annuity or a 401(k) plan. Or, if the salary deferrals exceed the \$11,000 or \$12,000 maximum, they can remain tax exempt at the time they are deferred, if they are subject to a "substantial risk of forfeiture." The IRS and the courts have interpreted this substantial-risk-of-forfeiture requirement as one that requires forfeiture in the event of voluntary termination of employment. This area can be somewhat complex for those who already receive tax deferred payments into annuities and also have substantial severance pay amounts provided for in their contracts.

There is an exemption to these limitations for a "bona fide severance plan," which the IRS views as a severance plan that is not a "mere device to provide deferred compensation." The IRS has recently defined severance pay as payment to an employee because of termination of employment under an unanticipated set of circumstances rather than compensation that has been systematically deferred to employment termination. Unanticipated circumstances include circumstances beyond the terminated employee's control, such as downsizing or restructuring. Severance payments might also include special payments made to employees to encourage them to voluntarily terminate employment, as in a window-type early retirement incentive program. However, where a payment is structured to postpone the receipt of compensation until termination of employment in order to delay payment of income tax until benefits are received, the IRS views the arrangement as a deferred compensation plan rather than a severance arrangement, and taxes it on the later of two dates: 1) when it is earned or, 2) when it is nonforfeitable.

To be forfeitable, it must be conditioned upon the future performance of substantial services. It is taxed in the first year in which it is not subject to any substantial risk of forfeiture. Thus, if the contract provides that a superintendent is entitled to a certain payment at the time of employment termination without having to work any additional time for the right to that payment to "vest", the IRS will tax the superintendent on that payment while the superintendent is still working, because the right to that payment is nonforfeitable. The superintendent is then in the unenviable position of having to pay income tax on money not yet received.

The IRS has also stated that there is no withholding tax or FICA tax obligation on such payments until the amount is readily ascertainable and not subject to restriction. This likely occurs when the superintendent has reached the age where s/he is entitled to, and fully vested in the benefit. At that time, the entire amount will be subject to FICA tax, even if part of it is paid in later years. It will be subject to withholding tax at the time of employment termination, even though installment payments over several years may be the distribution option selected.

It is therefore in your interest to structure your severance pay provision to be a "bona fide severance plan." The law remains somewhat uncertain in this area, but because of potential income tax implications it is recommended:

- (i) Your severance payments should be contingent upon the occurrence of certain future events. This requires you to forfeit pay in some situations such as voluntary termination of your employment. With a risk of forfeiture, you will not be taxed until you terminate employment.

If you are not prepared to build in a forfeiture risk, you should specify a payment schedule. You will be taxed when there is no risk of forfeiture, even if you are still working.

- (ii) The payment schedule should be specified in the contract and may provide for payments of up to five years.
- (iii) If you do not specify the payment schedule in the contract, you should try to have it decided (by you and the board, or by the board) by the end of the second calendar year before your termination of employment (i.e. by December of 2002, if you intend to terminate in 2003).

6. Conclusion.

In order to have a complete severance pay provision, you should address all of the above issues and cover all of them in the severance pay section of your contract. An example would be:

If the superintendent's employment with the school district is involuntarily terminated without cause for any reason, including the district's decision to not renew this contract, or if the superintendent terminates employment because of retirement, disability or death, the superintendent shall be paid severance pay in an amount equal to ten days' pay (daily rate is the last year's annual salary divided by 240) for each year of employment in the district, up to a maximum of six months' pay, plus payment for one-half of the unused accumulated sick leave days. One-half of the total amount shall be paid on the last day of employment, and the remainder shall be paid on the second day of the next calendar year. If the superintendent dies before the entire amount is paid, it shall be paid to the superintendent's named beneficiary, or if there is none, to the superintendent's estate.

Another example:

Upon the retirement, termination due to total and permanent disability or death of the superintendent, or if the school board terminates the superintendent's employment during a contract term or decides not to offer the superintendent a subsequent contract to take effect upon the expiration of this contract, the superintendent shall be paid severance pay in the amount of \$25,000. The payments shall be made on a monthly basis, in the same amount the superintendent is paid per month at the time of termination, and payments shall continue under a schedule of up to two years until the total amount is exhausted. If the superintendent dies before the full amount is paid, the balance shall be paid to the superintendent's named beneficiary, or if there is none, to his estate.

Another example:

Upon the termination of employment of the superintendent for any reason, the school board shall pay the superintendent a deferred compensation payment determined as follows: 10% of the annual salary earned in each year up to the year of employment termination, subject to a cap of \$25,000. Payment shall be made in the form of a single lump sum payment. (Taxable for income tax purposes on each 10% when earned)

If payment based on final year of pay only, taxable for income tax purposes each year, up to the amount of the formula in that year.

Other examples include severance provisions in which your right to payment does not vest until you reach a certain age or number of years of service. Until you reach such a point, you will not have been "vested." However, superintendent contracts are term contracts which may expire before you meet the conditions entitling you in severance or retirement benefits. Therefore, as a "failsafe" to protect you from forfeiting benefits upon the contract expiration, the contract should also provide that you would receive the benefit upon its involuntary termination or non-renewal. Age-proration formulas that may avoid constructive receipt problems, however, such formulas can create age discrimination concerns. The conversion of all severance pay to sick leave might also achieve the same purpose, but runs the risk that there may be no or little severance pay if such leave as used up for an illness. Also, there may be problems with converting large severance packages to sick leave when significant sick leave has not been accrued.

Finally, in late 1999, the IRS issued an Interim Guidance that forestalls any District obligation to report severance/early retirement income for which there may otherwise be constructive receipt. However, a District may rely upon this relief from a reporting obligation, but only if the following criteria are met:

- A. The plan was in existence on December 22, 1999.
- B. The plan is a broad-based plan maintained by a state or local government employer primarily for non-highly compensated employees.

C. The plan is nonelective. That is, the plan must not provide the participant with a choice between current and future compensation.

D. The plan has been treated by the state or local government as a bona fide severance pay plan under section 457(e)(11) for those years before calendar year 1999 in which the plan was in existence.

E. The plan satisfies the following three requirements:

- a. Payments under the plan are designed to provide supplemental income for a transitional period, rather than to provide retirement income.
- b. Payments under the plan are made only after separation from service with the employer, including retirement.
- c. Payments are completed within a short period of time, not to exceed 5 years, after separation from service.

This is not a blanket protection. For example, it would not apply to severance packages for members who are not part of a "broad-based plan" intended "primarily for non-highly-compensated employees" (i.e., those earning under \$85,000 in 2000). Each contract should be reviewed individually to determine whether the Interim Guidance applies. Moreover, the Interim Guidance, as the name makes clear, is only an interim measure pending a permanent guidance expected some time in 2000.

In summary, all members should review their current severance pay provisions, including those in which severance or "early retirement" pay are based upon similar provisions in teacher or principal contracts. MASA legal counsel can review and advise on the enforceability and constructive receipt implications of any severance or early retirement pay provisions. Before making modifications, please call MASA.