CARLTON FIELDS

Tax Reform and Accumulated Leave (aka “Special Pay”) Plans

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NOVEMBER 20, 2017

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Provisions in the current proposed Senate tax reform bill would likely reduce the effectiveness of retirement plan arrangements that regularly receive contributions of unused leave for former employees, commonly known as “accumulated leave” or “special pay” plans. As a result, affected entities and individuals would be subjected to greater employment taxation and more immediate income taxation.

Accumulated Leave Plans help any employer (governmental, nonprofit, or for profit) that allows unused leave to rollover to future years, if the employees are ultimately entitled to a payment for such unused leave on termination of employment.[1] Rather than make a single (often “large”) cash payment to the employee on termination, the payment is made to a retirement plan that delays income taxation and, if structured as a mandatory employer contribution, eliminates the employee and employer portion of employment taxation. The annual limit on total contributions changes annually, and is $54,000 for 2017 and will be $55,000 for 2018. When entities have many long term employees who are owed payments that far exceed this threshold, they structure excess contributions to spill over from the main retirement plan (often a 401(a) plan) into a 403(b) plan and, sometimes, a governmental 457(b) plan. In addition to the benefit of separate thresholds, the ability to make contributions to a 403(b) plan for former employees for up to five years after their employment terminates can also be especially useful with accumulated leave payments. Instead of excess payments spilling over to other plans, they are held and contributed in following years.

The proposed Senate tax reform bill provides for combined limits among 401(a), 403(b), and governmental 457(b) plans, and eliminates the ability of 403(b) plans to accept contributions for former employees for up to five years following termination of employment. If these provisions are included in the final tax reform bill, then more payments of accumulated leave will need to be made in a direct cash payment to the former employee, as opposed to being contributed to a retirement plan. The result will be greater employment taxation on the employer and former employee, and more immediate income taxation on the employee.

The effective date for these proposed changes is currently listed as the first day of the first plan year beginning after December 31, 2017, which means “January 1, 2018” for calendar year plans and, for fiscal year plans, the first day of the plan year beginning in 2018. In addition to paying attention to whether these reforms are adopted, plan sponsors must pay attention to the effective dates, as accumulated leave payments are often triggered throughout the year as employees and employers sever their employment relationship.

[1] NOTE: Employers that allow for a carryover of unused leave to later years, but allow employees to make an annual election to either (a) receive a payment for some or all of that leave, or (b) roll some or all of that leave to later years, generally do so in violation of the Internal Revenue Code, as this type of choice normally creates an improper cash or deferral arrangement (aka an improper 401(k) plan).