

MEMORANDUM OF LAW

DATE: November 20, 1995

TO: Bob W. Lawrence, Payroll Manager, Auditor's Office

FROM: City Attorney

SUBJECT: Pay-out of Annual or Sick Leave

QUESTION PRESENTED

Can payments to a retiree of accumulated annual or sick leave be deferred and paid out over a three or five year period with the related tax burden also deferred?

SHORT ANSWER

No. Vacation and sick leave plans are specifically precluded from being treated by state and local governments as a deferred compensation plan by the Internal Revenue Code. Thus, while the payments may be deferred, the tax consequences on the full amount of money due may not.

BACKGROUND

Recently, as a result of catastrophic leave donations, an employee died leaving an annual leave accumulation in excess of 2,000 hours. The amount due to the surviving spouse for payment of the leave accumulation was greater than one hundred thousand dollars (\$100,000). Because the amount at issue was large, a question was raised as to whether the monies could be paid out over several years. This proposal raised concerns about the tax consequences of paying the monies owed in installments over a number of years.

Under Administrative Regulation ("A.R.") 95.90, retirees may elect to have their accumulated annual leave and/or sick leave paid over a three or five year period, rather than in one lump sum at retirement. Taxes on these amounts are withheld at the time the payments are made. However, no similar provision is made for disbursement of accumulated annual and/or sick leave funds upon the death or termination of an employee. You have asked if the provisions of A.R. 95.90 comport with the federal tax laws and may be extended to payments upon the death or termination of an employee, as well as at the retirement of an employee.

ANALYSIS

Deferred compensation plans allow income earned in one taxable year to be paid out and taxed in a different year. The provisions of A.R. 95.90 imitate a deferred compensation plan in that they allow income in the form of accumulated annual leave and/or sick leave to be paid out in taxable years other than the year in which the amounts were earned or

used, that is, upon retirement. However, unlike a deferred compensation plan, these monies are available for use by the employee at any time during the employment period so long as the employee complies with applicable City policies such as the pay-in-lieu provisions of the Memoranda of Understanding with the labor organizations.

Deferred compensation plans for state and local governments which qualify under the terms of 26 U.S.C. Section 457, are accorded special tax treatment. However, to qualify for the special treatment a plan must meet certain Internal Revenue Code requirements. Under Section 457(e)(11), "any bona fide vacation leave, sick pay, compensatory time, severance pay, disability pay, or death benefit plan shall be treated as a plan not providing for the deferral of compensation." 26 U.S.C. Section 457 (e)(11) (emphasis added). A qualified deferred compensation plan allows an individual to delay receipt of monies earned until a future date. It also allows deferral of the tax consequences of those earnings. Monies are deemed received in the year they are earned unless they are deferred pursuant to a qualified deferred compensation plan.

Qualified deferred compensation plans require an employee to make an irrevocable election to defer income until a date certain in the future. Such plans impose significant tax penalties if an individual elects to make an early withdrawal of deferred funds, even in cases of hardship withdrawals. A.R. 95.90 does not require an election until the employee has constructive receipt of the monies, that is at the time the monies are fully due and payable. Constructive receipt of income "as applied to tax laws, is taxable income which is unqualifiedly subject to the demand of taxpayer on cash receipts and disbursements method of accounting, whether or not such income has actually been received in cash." Black's Law Dictionary (6th ed. 1990). No penalties accrue if an employee elects to take all the funds at the time of termination. A.R. 95.90 also provides for no penalties if the employee changes his or her mind during the payout term and demands all the remaining monies. Finally, no election as to the future disposition of the funds is required of an employee during the term of employment.

Thus, the provisions of A.R. 95.90 do not meet true deferred compensation requirements even if plans for leave balances to be deferred were not prohibited under the code.

CONCLUSION

Under the specific provisions of the Internal Revenue Code, accumulated leave time may not be treated as deferred compensation. Thus, although an employee may be paid over three to five years, the money is taxable at the time an employee has access to it, or upon retirement or death. A.R. 95.90, therefore, should be amended to comport with the requirements of the Internal Revenue Code.

JOHN W. WITT, City Attorney

By
Sharon A. Marshall
Deputy City Attorney

SAM:jrl(x043.2)

ML-95-83