Internal Revenue Service

Department of the Treasury

Index Numbers: 61.00-00 83.00-00
402.01-00 451.00-00

Washington, DC 20224

Number: **200027044**
Release Date: 7/7/2000

Person to Contact:

Telephone Number:

Refer Reply To:
CC:EBEO:Br1– PLR-114008-99
Date:
April 3, 2000

Employer =

Retirement System =

This is in response to your letter dated August 10, 1999, requesting a ruling on behalf of Employer and Retirement System concerning the federal income tax consequences of certain contributions to Retirement System proposed to be made on behalf of employees of Employer measured by the value of accumulated unused sick pay.

Employer is a political subdivision of a state. Retirement System is a nonprofit corporation that administers retirement, disability, death and survivor benefits for employees of the Employer and employees of the Retirement System. The retirement program operated by Retirement System includes a defined benefit plan that is intended to be a qualified plan under § 401(a) that is a governmental plan as described in § 414(d) (the Defined Benefit Plan).

Under the Retirement System's current sick leave conversion program, employees are permitted a set number of days of sick leave annually, and can accumulate unused sick leave as credits in their sick leave account from year to year, subject to a maximum. Unused sick leave remaining credited to an employee's sick leave account at retirement is counted toward creditable service for purposes of determining the employee's benefit under the Defined Benefit Plan. However, creditable service under the Defined Benefit Plan is limited to 30 years.

Employer and Retirement System are proposing a change to this sick leave conversion program to provide employees with a supplemental retirement benefit under the Defined Benefit Plan on account of accumulated unused sick leave under certain circumstances, instead of crediting accumulated unused sick leave as additional creditable service. Under this proposed change, an employee who retires on account of disability, or after providing advance notice of intent to retire as specified under the sick leave conversion program, will receive a supplemental benefit under the Defined Benefit Plan based on a fixed percentage of the value of the employee's accumulated unused sick leave credits (which will be contributed by Employer to Retirement System). An employee who receives this supplemental benefit under the Defined

Benefit Plan will not have additional service credited under the Defined Benefit Plan on account of the accumulated unused sick leave credits. The employee may elect the form of payment of this supplemental benefit from among several options. An employee who retires without providing the specified advance notice of intent to retire and who does not retire on account of disability will not receive this supplemental benefit under the Defined Benefit Plan. Instead, additional service will be credited toward the employee's benefit under the Defined Benefit Plan based on the employee's accumulated unused sick leave credits (to the extent credited service does not exceed 30 years), as is the case under the current sick leave conversion program.

Section 457 of the Code provides rules regarding the taxation of deferred compensation plans of eligible employers. For this purpose, the term "eligible employer" is defined in § 457(e)(1) as a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state, and any other organization (other than a governmental unit) exempt from tax under subtitle A of title 1 of the Code. The Employer is an eligible employer within the meaning of § 457(e)(1).

Under § 457(e)(11)(A)(i), a bona fide sick leave plan is treated as not providing for the deferral of compensation for purposes of § 457. In the present case, the primary function of the Employer's program for the crediting and use of sick leave (including the proposed change to the sick leave conversion program) is to provide employees with paid time off from work when necessary because of sickness. Thus, the sick leave conversion program (including the proposed change) is part of a bona fide sick leave plan within the meaning of § 457(e)(1) notwithstanding that the planned contributions to the Retirement System pursuant to the sick leave conversion program will result in a deferral of compensation. Accordingly, the rules of § 457 do not apply to the sick leave conversion program (including the proposed change).

Section 451(a) of the Code and § 1.451-1(a) of the regulations provide that an item of gross income is includible in gross income for the taxable year in which it is actually or constructively received by a taxpayer using the cash receipts and disbursements method of accounting. Under § 1.451-2(a), income is constructively received in the taxable year during which it is credited to a taxpayer's account or set apart or otherwise made available so that the taxpayer may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Rev. Rul. 75-539, 1975-2 C.B. 45, addressed two fact patterns under which sick leave accumulated by a retiring employee could be applied to the cost of accident and health insurance. In the first fact pattern, a retiring employee can receive a cash payment for accumulated sick leave or have the payment applied to the cost of the insurance. The ruling concludes that unused sick leave credits that are received in cash are includible in the retiree's gross income under § 61 of the Code. Further, a retiree's ability to relinquish the right to the cash payment and have such an amount applied to the

payment of health insurance premiums results in constructive receipt of such amount under § 451. In the second fact pattern, the employer places accumulated sick leave credits in an escrow account to pay the health insurance premiums until those amounts are exhausted. The retiring employee cannot elect to receive accumulated sick leave in cash. The ruling concludes that, since the value of the accumulated unused sick leave credits is placed in escrow by the employer solely for the payment of health insurance premiums and may not in any event be received in cash by the employee or the employee's dependents or beneficiaries, those amounts are not constructively received under § 451.

Under the proposed change to the sick leave conversion program, the conversion of accumulated unused sick leave credits to additional benefits under the Defined Benefit Plan (either as a supplemental benefit or by reason of additional service credits) is automatic and mandatory. No amount is constructively received by an employee when the employee provides advance notice of intent to retire or files an election as to manner of payment of the supplemental benefit, or when the Employer contributes additional amounts to the Retirement System on account of the unused sick leave, because the employee cannot elect to receive any amount in cash in lieu of the additional Defined Benefit Plan benefit provided on account of the unused sick leave.

Under the assignment of income doctrine, a gratuitous anticipatory assignment of income does not shift the burden of taxation and the donor is taxable when the income is received by the donee. See Helvering v. Horst, 311 U.S. 112 (1940) and Lucas v. Earl, 281 U.S. 111 (1930). In Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958), the taxpayers assigned the right to a specified sum of money, payable out of a specified percentage of oil, or the proceeds received from the sale of such oil, if, as and when produced in return for cash. The Court concluded that, while the oil payments were interests in land, the consideration received for the oil payment rights was taxable as ordinary income because the lump sum consideration was essentially a substitute for what would otherwise be received at a future time as ordinary income.

Under the proposed change to the sick leave conversion program, the conversion of accumulated unused sick leave credits to additional benefits under the Defined Benefit Plan (either as a supplemental benefit or by reason of additional service credits) is automatic and mandatory. Distributions of amounts contributed under the Defined Benefit Plan for these additional benefits will be subject to the rules for qualified plan distributions under the Code. Under no circumstances will an employee be eligible to receive any amount in cash in lieu of accruing these additional benefits under the Defined Benefit Plan. Therefore, the corresponding contributions to the Defined Benefit Plan will not be a substitute for amounts the employee would otherwise receive as current compensation. Accordingly, the assignment of income doctrine will not apply to the proposed transaction.

Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, though not in cash form. The economic benefit doctrine applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 51 (6th Cir. 1952); Rev. Rul. 60-31, Situation 4, 1960-1 C.B. 174.

Section 83(a) of the Internal Revenue Code provides that the excess (if any) of the fair market value of property transferred in connection with the performance of services over the amount paid (if any) for the property is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferrable or is not subject to a substantial risk of forfeiture. Section 83(e)(2) provides that section 83(a) does not apply to a transfer to a trust described in section 401(a).

Section 402(a) of the Code provides that any amount actually distributed to any distributee by an employees' trust described in § 401(a) that is exempt from tax under § 501(a) is taxable to the distributee in the taxable year of the distributee in which distributed.

Section 1.402(a)-1(a)(1)(i) of the regulations provides that if an employer makes a contribution for the benefit of an employee to a trust described in § 401(a) for the taxable year of the employer that ends within or with a taxable year of the trust for which the trust is exempt under § 501(a), the employee is not required to include the contribution in gross income except for the year or years in which the contribution is distributed or made available to him. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter. Under the proposed change to the sick leave conversion program, contributions made by Employer to Retirement System on account of the additional benefits under the Defined Benefit Plan that arise from unused sick leave credits are employer contributions within the meaning of § 1.402(a)-1(a)(1)(i) to which the economic benefit doctrine and § 83(a) of the Code do not apply.

Based on the information submitted and representations made, we conclude that:

1. The Employer's contributions to fund additional benefits under the Defined Benefit Plan that arise from the proposed change to the sick leave conversion program, measured by the value of accumulated unused sick leave credits, are employer contributions which will be excluded from the gross income of retired employees until paid under the Defined Benefit Plan.

2. The conversion of accumulated unused sick leave credits to an amount used as a basis for calculating employer contributions to fund the supplemental benefit under the

Defined Benefit Plan will not create taxable income for participants using the cash receipts and disbursements method of accounting under the economic benefit doctrine or the constructive receipt doctrine of § 451 of the Code, the anticipatory assignment of income doctrine, or § 83 at the time of the filing of notice of intent to retire or the election of form of payment of the supplemental benefit, or at the time corresponding contributions to the Retirement System are made by the Employer. The rules of § 457 do not apply to this conversion of accumulated unused sick leave credits, because this conversion is part of a bona fide sick leave plan.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed regarding the qualified status of the Defined Benefit Plan under § 401(a) or the effect of the modifications discussed in this letter on that qualified status.

This ruling is directed only to the taxpayers who requested it and applies only to the draft sick leave conversion program and regulations submitted with your letter of August 10, 1999. If these documents are changed, this ruling may not necessarily remain in effect. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to both taxpayers.

Sincerely,
Robert D. Patchell
Assistant Chief, Branch 1
Office of the Associate Chief Counsel
(Employee Benefits and Exempt Organizations)

Enclosure:
Copy of 6110 purposes