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Person To Contact:
, ID No.
Telephone Number:

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State X=
EIN =

Dear :

This is in response to your letter of , and subsequent correspondence, on behalf of State X, regarding its proposal to amend its leave program.

State X currently has a comprehensive leave program which offers its employees annual leave, personal leave, school participation leave, and sick leave. State X wants to increase the amount of annual leave under State X's leave program. This increase in leave will result from negotiations between State X and its collective bargaining units. These units cover a significant number of State X's employees. This additional annual leave will result in concessions by State X's collective bargaining units and may lower State X's budget costs. The concessions may include unpaid hours, forgone salary increases, longevity payment reductions, changes in health premium payments, or other similar concessions. Employees not in the collectively-bargained units will be offered the same leave options. Similar concessions will also be made applicable to non-exclusively represented employees as approved by State X's Civil Service Commission.

The program of additional leave that State X will be offering after amendments of its leave program will be referred to herein as Part B. State X represents that employees will be able to use all of the leave offered under the new leave program.

No individual employee will have any election or choice regarding whether or to what extent they wish to participate in Part B. Not only will participation by all affected State X employees be mandatory, but the amounts of leave time granted under Part B will be fixed without employee choice, either by agreement of the bargaining representatives or as set by the State for non-exclusively represented employees.

As under the State's current leave program, hours accumulated under Part B may be taken in kind as paid leave time off at any time during the year in which they are accumulated, or in any later year up until the time the employee retires or otherwise terminates employment.

Under Part B, the value of any unused leave remaining at retirement or termination (based on the employee's then current wage rate) will be contributed to State X's defined contribution plan, which is qualified under section 401(a) (401(a) plan), or its eligible section 457(b) plan (457(b) plan). The 401(a) plan currently provides for both employer nonelective and matching contributions, as well as elective deferrals grandfathered under section 401(k). The 457(b) plan currently permits elective contributions and is designed and intended to satisfy all of the requirements of section 457(b) for an eligible deferred compensation plan and the trust requirement of 457(g) that is applicable to governmental plans. Amendments to both the 401(a) and 457(b) plans to permit these contributions under the Part B program will be adopted.

This allocation among the State's plans will be made automatically pursuant to Part B and without any employee choice or election involved, subject to any applicable limits on contributions under sections 415 and 457(b). An exception to this is that the value of Part B hours which are not eligible for nonelective contribution treatment under this ruling may, at separation, death or retirement from state service, be taken in cash or contributed to the State's 401(a) or 457(b) plan (by making an election before the amounts become currently available, in the case of the 401(a) plan, and before the beginning of the month in which the amount would otherwise be paid, in the case of the 457(b) plan). It is anticipated that these plan contributions will be made in the year that the employee retires or terminates, but contributions may be made in the year immediately preceding retirement/termination if the employee provides advance notice thereof, the State projects that contributions would otherwise exceed the applicable limits for the final year, and such contribution would otherwise meet the requirements of section 401(a) or 457(b).

In the event that an employee fails to use all of his accumulated Part B leave time and the applicable plan limits prevent the value of the remaining leave time from being contributed to the State's 401(k) or 457(b) plans, the balance of any unused leave time will be forfeited.

State X also offers an approved leave of absence. An ”approved leave of absence” is unpaid leave for medical, family-related, educational, military service, political candidacy, union service or similar restricted purposes as set forth in the rules and regulations promulgated by the State X Civil Service Commission and approved by State X.

RULINGS REQUESTED

You have requested the following rulings.

1. State X's comprehensive Annual and Sick Leave Program constitutes a "bona fide leave program" under section 457(e)(11), the primary function of which is to provide eligible employees with paid time off from work for vacation, illness or other personal reasons, and the rules of section 457 are not applicable to the program at any time, except at the time and to the extent that the value of any such leave time is actually contributed to State X's 457(b) plan.

2. Neither the accumulation of annual and sick leave program leave time, nor the State's contribution of the value of any unused Part B leave remaining at the time of an employee's retirement or termination of employment, to the State's 401(a) plan or 457(b) plan (as limited by section 415 and section 457(b)(2) or (3), respectively), will result in the inclusion of the value of such leave time in the employee's income under section 451 or 457, or under the constructive receipt, economic benefit or anticipatory assignment of income doctrines, for any of the year(s) prior to or during the year in which such amounts are so contributed.

3. Except to the extent that, following the inception of the Part B program, an employee has voluntarily taken leave without pay (other than for an approved leave of absence) at a time when the employee has unused Part B paid leave available, the State's contribution of any unused Part B leave to the State's 401(a) plan is not an elective contribution that is made pursuant to a cash or deferred election within the meaning of section 401(k)(2)(A) and section 1.401(k)-1(a)(3)(i) of the Income Tax Regulations. Rather, the State's contribution of such Part B leave time to the 401(a) plan under the program is a nonelective employer contribution.

4. Except to the extent that, following the inception of the Part B program, an employee has voluntarily taken leave without pay (other than for an approved leave of absence) at a time when the employee has unused Part B paid leave available, no amounts of Part B leave time accumulated or contributed in accordance with the Annual and Sick Leave Program will be includible in the employee's gross wages for purposes of Federal Insurance Contributions Act (FICA) taxes under section 3121, except at the time and to the extent that the value of any such leave time is actually contributed to the State's 457(b) plan.

ANALYSIS

Our analysis of ruling request one is as follows. Section 457 provides rules regarding the taxation of deferred compensation plans of eligible employers. For this purpose, the term eligible employer is defined in section 457(e)(1)(A) as a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state. State X is an eligible employer within the meaning of section 457(e)(1)(A).

Section 457(b) and section 1.457-2 set forth the requirements for an eligible deferred compensation plan, including rules for participation, deferral of compensation, and payment of benefits. Pursuant to section 457(b)(2), an eligible deferred compensation plan must provide that the maximum amount that may be deferred under the plan shall not exceed the lesser of the applicable dollar amount ($12,000 in 2003) or 100 percent of the participant's includible compensation.

Under section 457(e)(11)(A)(i), a bona fide sick or vacation leave plan is treated as not providing for the deferral of compensation for purposes of section 457. The Service has not issued formal published guidance as to what constitutes a bona fide sick or vacation leave program. However, in determining whether a program is bona fide, some of the factors that may be considered are: whether the amount of annual leave or the total amount of leave offered is excessive, whether the program is available only to a limited number of employees, and whether the facts indicate that there is a reasonable expectation that employees will be able to use all of the leave provided under the program. For example, factors that would tend to indicate that a program is bona fide and not a mere device to defer compensation would include whether a leave program is collectively bargained or broad-based. In the present case, the relevant facts and circumstances indicate that State X's comprehensive Annual and Sick Leave program is a bona fide sick or vacation leave plan within the meaning of section 457(e)(11). Accordingly, the rules of section 457 are not applicable to the program, except at the time and to the extent the value of any such leave is actually contributed to State X's 457(b) plan.

Our analysis of the second ruling request is as follows. Section 83(a) 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 transferable 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) provides that any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee in the taxable year of the distributee in which distributed, under section 72 (relating to annuities).

Section 1.402(a)-1(a)(1)(i) provides that if an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in gross income except for the year or years in which such 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.

Section 451(a) and section 1.451-1(a) provide that an item of gross income is includible in the 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 section 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.

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.

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 could 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 section 61. 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 section 451. In the second fact pattern, the employer will place accumulated sick leave credits in an escrow account to pay the health insurance premiums until such amounts are exhausted and 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, such amounts are not constructively received under section 451.

Under the proposed arrangement, the conversion of accumulated unused vacation leave into a Plan contribution is automatic and mandatory. The employee's receipt of the accumulated vacation leave is not constructively received because under no circumstances will an employee be eligible to receive any of the unused vacation leave credits accumulated before separation from service or retirement in cash.

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, 218 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 interest 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. In other words, the taxpayer converted future income into present income and was taxable on such present income.

Under the proposed arrangement, each employee's unused vacation leave will be converted automatically into a contribution to either the 401(a) plan or the 457(b) plan. Distributions of amounts contributed will be subject to the rules for 401(a) plans and 457(b) plans under the Code. Under no circumstances will an employee be eligible to receive any of the unused vacation leave credits accumulated before separation from service or retirement in cash. Therefore, an employee cannot voluntarily forego future taxable income for other consideration and the plan contributions will not be a substitute for amounts that the employee would otherwise receive as current compensation. Accordingly, neither the accumulation of Part B leave time, nor State X's contribution of any unused Part B leave remaining at the time of an employee's retirement or termination of employment, to the State's 401(a) plan or 457 (b) plan (as limited by sections 415 and 457(b)(2) or (3), respectively) will result in the inclusion of the value of such leave time in the employee's income under sections 451 or 457, or under the constructive receipt, economic benefit or anticipatory assignment of income doctrines, for any of the years prior to or during the year in which such amounts are so contributed.

Our analysis of the third ruling request is as follows. Section 401(k)(2)(A) provides, in pertinent part, that a qualified cash or deferred arrangement is any arrangement which is part of a profit sharing plan or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan, which meets the requirements of section 401(a), and under

which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash.

Section 1.401(k)-1(a)(3)(i) provides that a cash or deferred election is any election by an employee to have the employer either: (A) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available, or (B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. A cash or deferred election includes a salary reduction agreement between an employee and employer under which a contribution is made under a plan only if the employee elects to reduce cash compensation or to forgo an increase in cash compensation.

Section 1.401(k)-1(g)(10) defines nonelective contributions as employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

Section 1.401(m)-(f)(12) defines matching contributions as: (A) any employer contribution (including contributions made at the employer's discretion) to a defined contribution plan on account of an employee's contribution to a plan maintained by the employer, (B) any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an elective deferral (as defined in section 1.402(g)-1(b)); and (C) any forfeiture allocated on the basis of employee contributions, matching contributions or elective contributions.

Under Part B of State X's leave program, except to the extent that, following the inception of the Part B program, an employee has voluntarily taken leave without pay (other than for an approved leave of absence) at a time when the employee has unused Part B paid leave available, an employee does not have a choice to receive a cash payment or other taxable benefit for this leave. An employee's only choice is to use the leave or have its value contributed to the 401(a) plan or the 457(b) Plan. Thus, subject to the exception in the first sentence of this paragraph, the contribution of the value of Part B leave to the 401(a) plan is not an elective contribution pursuant to a cash or deferred election.

Moreover, the value of Part B leave contributed to the 401(a) plan is not based upon any contribution by an employee. Therefore, the contribution is not a matching contribution.

In view of the foregoing, we conclude with respect to ruling request number three that, under current regulations, except to the extent that, following the inception of the Part B program, an employee has voluntarily taken leave without pay (other than for an

approved leave of absence) at a time when the employee has unused Part B paid leave available, the contribution of the value of Part B leave to State X's 401(a) plan is a nonelective contribution rather than an elective contribution pursuant to a cash or deferred election.

With respect to the fourth ruling request, we note the following. Section 3121(b)(7) excludes service for a state or local government from employment for FICA purposes. However, section 3121(b)(7)(F) provides an exception to section 3121(b)(7) if the employee is not a member of a state retirement system. Whether a retirement arrangement is a state retirement system generally depends upon whether the retirement arrangement provides benefits equivalent to social security benefits.

If the employees are members of a retirement system and, therefore, exempt from FICA tax under section 3121(b)(7)(F), they may nevertheless be subject to the Medicare portion of FICA taxes. Under section 3121(u)(2)(C), all state or local government employees hired after March 31, 1986, are subject to Medicare tax regardless of membership in a retirement system.

Even though state or local government employees are covered under a retirement system within the meaning of section 3121(b)(7)(F), the state may also choose to cover its employees under social security by entering into an agreement with the Social Security Administration. These agreements are commonly referred to as "section 218 agreements." Under section 3121(b)(7)(E), service covered under a section 218 agreement is excepted from the section 3121(b)(7) exclusion.

For purposes of this response, we assume that the State X employees at issue are covered under FICA by reason of section 3121(b)(7)(F) or 3121(u), or, if the employees are members of a state retirement system within the meaning of section 3121(b)(7)(F), because the State has entered into a section 218 agreement with the Social Security Administration. Given this assumption, the rules regarding the FICA tax treatment of qualified retirement plan benefits and state or local government retirement plan benefits govern in determining whether and when retirement benefits provided under the leave program will be subject to FICA tax.

With respect to contributions to be made to the 401(a) plan, our analysis is as follows. Section 3121(a)(5)(A) excludes from wages any payments made to or from a trust that is part of a qualified plan. This exception applies regardless of whether the employer is a state or local government.

However, section 3121(v)(1)(A) provides that any employer contributions under a qualified cash or deferred arrangement (as defined in section 401(k)) are not excepted from wages under section 3121(a)(5)(A) to the extent such contributions are not included in gross income by reason of section 402(e)(5) (excluding elective deferrals

from gross income). Thus, employee elective deferrals are subject to FICA tax at the time of the contribution to the trust.

Accordingly, whether contributions to the 401(a) plan pursuant to the leave program are FICA wages depends upon whether the contributions are elective deferrals. Since we have concluded that, under current regulations, except to the extent that, following the inception of the Part B program, an employee has voluntarily taken leave without pay (other than for an approved leave of absence) at a time when the employee has unused Part B paid leave available, the Part B contributions to the 401(a) plan under the leave program are not elective deferrals, they are (subject to the same exception) not subject to FICA taxation.

With respect to contributions to be made to the 457(b) plan, our analysis is as follows. Section 3121(a)(5)(E) provides that payments made under or to an exempt governmental deferred compensation plan as defined in section 3121(v)(3) are not wages. Section 3121(v)(3) provides that the term "exempt governmental deferred compensation plan" means any plan providing for deferral of compensation other than any plan to which, inter alia, section 457(a) applies (section 457(b) defines a plan to which section 457(a) applies). Notices 2000-38, 2000-2 C.B. 174, and 2003-20, 2003-19 I.R.B. 894, state that payments under a section 457(b) plan are subject to FICA tax based upon section 3121(v)(2) and the regulations thereunder. Thus, payments to a section 457(b) plan are FICA taxable. If section 3121(v)(2) is properly applied, distributions from a section 457(b) plan are not FICA taxable based upon the nonduplication rule under section 3121(v)(2)(B).

Regarding timing, section 3121(v)(2) provides special timing rules that determine when amounts deferred under a nonqualified deferred compensation plan (including employers' contributions) are required to be taken into account. Under this section, an amount deferred under a nonqualified deferred compensation plan, including a section 457(b) plan, is required to be taken into account for purposes of FICA taxes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to such amount.

Notice 2003-20, Part VI, C, Example 1, describes a section 457(b) plan that provides for elective deferrals from current salary as well as a one percent of salary nonelective contribution for each employee. All deferrals and contributions, including the state's contributions, are described as fully and immediately vested.

The example concludes that because these contributions are not subject to a substantial risk of forfeiture (and the services to which they relate have already been performed), the elective deferrals are required to be taken into account as wages at the time of the deferral and the state's nonelective contributions are required to be taken into account as wages at the time of the contribution for purposes of FICA tax.

Contributions to State X's 457(b) plan will not be subject to a substantial risk of forfeiture (and the services to which they relate will have already been performed). Thus, the contributions will be subject to FICA tax at the time of contribution. No amounts of Part B leave time accumulated or contributed in accordance with State X's leave program will be includible in the employee's gross wages for purposes of FICA, except at the time and to the extent that the value of any such leave time is actually contributed to the State's 457(b) plan.

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the leave program under any other provision of the Code. If the program is modified, this ruling will not necessarily remain applicable.

This ruling is directed only to State X and applies only to the program submitted by a transmittal letter dated April 10, 2003, as revised by amendments submitted on August 8, 2003 and September 5, 2003. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusions in this ruling. See section 12.04 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, 44. However, when the criteria in section 12.06 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, 45 are satisfied, a ruling is not revoked or modified except in rare or unusual circumstances.

Sincerely yours,

ROBERT D. PATCHELL
Chief
Qualified Plans Branch Two
Office of the Division Counsel/
Associate Chief Counsel