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CC:TEGE:QP2 - PLR-167048-01

September 30, 2002

Legend

Entity E =

Dear :

This responds to your letter of December 6, 2001 and subsequent correspondence, on behalf of Entity E, requesting a ruling concerning the application of sections 106, 403(b), (451(a)) and 457 of the Internal Revenue Code (the “Code”) to E’s Unused Sick Leave Conversion and Early Retirement Benefits Plan (the “Plan”) which E intends to implement for its eligible employees in the near future. E is represented to be a school district which is an eligible governmental employer described in section 457(e)(1)(A) of the Code.

E intends to revise its pre-existing sick leave and personal leave programs providing qualified members of its staff with paid time off for sick days and personal days. Within limits these programs allow employees to accumulate unused sick and personal leave from year to year. E’s proposed Early Retirement Benefits Plan (the “Plan”) provides eligible employees of E who retire before the normal age 65 retirement date in accordance with the Plan’s terms with a variety of benefits depending partly on the accumulated unused amounts in their sick and personal leave accounts on the date they retire and partly on the number of years between their early retirement date and the year when they attain age 65. The Plan does not provide E’s employees with any election of the form of benefits to be provided to qualifying early retirees. You have represented that E’s Plan will become effective only after E has received this ruling.

To become a participant in E’s Plan, an eligible employee seeking to retire before age 65 at the end of a school year must timely file an early retirement application with E, which then, in its absolute discretion, accepts or rejects the employee’s application. Approved applicants are then entitled to receive certain benefits described below as of the date they retire early.

Under the Plan, E will determine an amount (the “Benefits”) equal to the value of all unused sick pay and special leave pay when an employee retires pursuant to the Early Retirement Plan. E will then use the Benefits to provide a series of pension and/or welfare benefits predetermined by the Plan with no election allowed to the employee. We have been asked to determine whether section 457(f) of the Code applies to any of the benefits provided under the Plan.

First, the Benefits are used to provide post retirement health coverage. An amount will be determined to provide health insurance coverage for the retiring employee from retirement until age 65 based on E’s computed cost of coverage. Whenever a premium is due, until the retiree reaches age 65, E pays the required premium for health insurance coverage for the retiree and reduces the pre-determined cost of coverage by an amount equal to the paid premium. When the retired employee reaches age 65 and the actual cost of health insurance coverage from retirement to age 65 is less than the pre-determined cost of coverage computed when the employee retired, the difference will be paid to the retiree in a lump sum. Should the retired employee die before reaching age 65, the unused portion of the computed cost of health insurance coverage will be paid in a lump sum to the retiree’s beneficiaries.

Where Benefits remain in the employee’s sick and special leave accounts after payment for health coverage, the Employer makes nonelective contributions up to the section 403(b) and section 415(c) limitations pursuant to the Plan to the retiring employee’s tax-sheltered annuity benefit qualified under Code section 403(b). If an employee’s leave accounts still have Benefits remaining after the section 403(b) contributions, the Employer makes a contribution up to the annual statutory limit to an account in E’s section 457(b) eligible deferred compensation plan for the retiring employee. If Benefits for the retiree are still available in his leave accounts after this contribution, the remaining amount (the “excess benefits”) is paid in a lump sum, within a week after the employee retirees pursuant to E’s Plan. We have also been asked to determine whether such excess benefits will be taxable as wages under section 3121 of the Code.

Section 106 of the Code provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.106-1 of the regulations states that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by the employee, the employee's spouse, or the employee's dependents, as defined in section 152 of the Code. The employer may contribute to an accident or health plan either by paying the premium on a policy of accident or health insurance covering one or more of the employees, or by contributing to a separate trust or fund which provides accident or health benefits directly or through insurance to one or more of the employees. However, if the insurance policy, trust, or fund provides other benefits in addition to accident or health section 106 applies only to the portion of the contributions allocable to the accident or health benefits.

In Rev. Rul. 62-199, 1962-2 CB 38, the Service concluded that section 106 applies to retired employees as well as active employees.

Section 403(b)(1) of the Code states, in part, that amounts contributed by an eligible employer to a tax sheltered annuity arrangement which meets the requirements of section 403(b) on or after such rights become nonforfeitable shall be excluded from the gross income of the employee for the taxable year to the extent that the aggregate of such amounts does not exceed the applicable limit under section 415.

Section 403(b)(3) of the Code, as amended by the Job Creation and Worker Assistance Act of 2002, provides that, for purposes of section 403(b), the term "includible compensation" means, in the case of any employee, the amount of compensation which is received from the eligible employer described in section 403(b)(1)(A), and which is includible in gross income for the most recent period (ending not later than the close of the taxable year) which under section 403(b)(4) may be counted as one year of service, and which precedes the taxable year by no more than five years. The term "includible compensation" does not include any amount contributed by the employer for any annuity contract to which section 403(b) applies.

Section 403(b)(4) of the Code provides that, in determining the number of years of service for purposes of section 403(b), there shall be included - (A) one year for each full year during which the individual was a full-time employee of the organization purchasing the annuity for him, and (B) a fraction of a year (determined in accordance with regulations) for each full year during which such individual was a part-time employee of such organization and for each part of a year during which such individual was a full-time or part-time employee of such organization. In no case shall the number of years of service be less than one.

Section 415(a)(2) generally requires that for a section 403(b) arrangement to qualify for favorable tax treatment under section 403(b), it must comply with the section 415(b) limitation upon annual benefits from defined benefit plans or with the section 415(c) limitation upon annual contributions to defined contribution plans, whichever is applicable, and it must not have been disqualified under the section 415(g) aggregation of plans provision.

Section 415(c)(1) of the Code states that the limit on the amounts of annual additions (as defined in section 415(c)(2)) which may be contributed to an individual's account in all defined contribution plans (including tax-sheltered annuities described in section 403(b)) maintained by the employer in any one year is the lesser of (A) $40,000, or (B) 100 percent of the participant's compensation.

Section 415(c)(3)(E) provides that in the case of an annuity contract described in section 403(b), the term "participant's compensation" means the participant's includible compensation determined under section 403(b)(3).

As a result of these above-described section 403(b) and section 415 provisions, an eligible employer may make non-elective contributions to an employee's account in a section 403(b) plan up to the section 415(c) limit for each of the five years following the employee's most recent year of service, using compensation for that year in determining the applicable section 415(c) limit for each of those five years. Assuming contributions to E's tax-sheltered annuity satisfy such limits and that E's tax-sheltered annuity otherwise satisfies the requirements of section 403(b), such contributions would not be includible in gross income, provided they do not constitute contributions made pursuant to a salary reduction agreement.

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 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. E is an eligible employer within the meaning of section 457(e)(1)(A).

Section 457(b) of the Code and section 1.457-2 of the regulations define the term "eligible deferred compensation plan." Those provisions contain the various requirements for an eligible plan, including rules for participation, deferral of compensation, and payment of benefits. Pursuant to section 457(b)(2), an eligible plan must provide that the maximum amount that may be deferred under an eligible plan shall not exceed the lesser of the applicable dollar amount ($11,000 in 2002) 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. In the present case, the primary function of E's program for the crediting and use of sick and special leave (including the proposed Plan) is to provide employees with paid time off from work when appropriate because of sickness or for other personal reasons. Thus, the sick and special leave programs are part of a bona fide sick or vacation leave plan within the meaning of section 457(e)(11), notwithstanding that the permitted contributions to E's tax sheltered annuity arrangement and eligible deferred compensation plans pursuant to the Plan will result in a deferral of compensation. Accordingly, the rules of section 457(f) are not applicable to the leave programs before the employee qualifies for early retirement pursuant to the Plan. However, the extent to which section 457(f) applies to the Benefits under the Plan is discussed below.

Section 457(f) of the Code governs the tax treatment of a participant in a plan of an eligible employer, if the plan provides for a deferral of compensation, but is not an eligible deferred compensation plan. The term "eligible employer" is defined in section 457(e)(1), and includes a state or any political subdivision or any agency or instrumentality of a state, and any other tax-exempt organization. Section 457(f)(2) states that section 457(f)(1) does not apply to a plan described in section 401(a) which includes a trust exempt from tax under section 501(a), to an annuity plan or contract described in section 403, to that portion of any plan which consists of a transfer of property described in section 83, or to that portion of any plan which consists of a trust to which section 402(b) applies.

In general, section 457(f)(1)(A) of the Code provides that the amount of compensation which is deferred under a plan subject to section 457(f)(1) is included in the participant's or beneficiary's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation. Section 457(f)(3)(B) provides that, for purposes of section 457(f), the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual. This language is substantially similar to language contained in section 83 of the Code.

Section 451(a) of the Code and section 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 actually or constructively received by a taxpayer using the cash receipts and disbursements method of accounting. Under section 1.451-2(a) of the regulations, income is constructively received in the taxable year during which it is credited to the taxpayer's account, 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.

Various revenue rulings have considered the tax consequences of nonqualified deferred compensation arrangements. Rev. Rul. 60-31, Situations 1-3, 1960-1 C.B. 174, holds that a mere promise to pay, not represented by notes or secured in any way, does not constitute receipt of income within the meaning of the cash receipts and disbursements method of accounting. See also, Rev. Rul. 69-650, 1969-2 C.B. 106, and Rev. Rul. 69-649, 1969-2 C.B. 106.

Section 457(f) applies in this case to the excess benefit amounts remaining in an eligible employee's sick and special leave accounts after the employer has contributed the appropriate amounts for the employee's health insurance benefit and to the employee's accounts in E's section 403(b) and section 457(b) plans. The amounts credited to the retiring employee's health insurance account are excluded from his income under section 106 and do not constitute deferred compensation subject to section 457(f). Although the amounts properly contributed to the employee's section

403(b) and section 457(b) plan accounts constitute deferred compensation, they are excluded from the application of section 457(f) under sections 457(f)(2) and 457(b).

The employee is not subject to a substantial risk of forfeiture with respect to the excess benefit amounts remaining after E has contributed the appropriate amount to the eligible retiring employee's health insurance benefits and section 403(b) and section 457(b) plan accounts. Thus, the amount subject to immediate taxation under section 457(f) is the excess benefit amount still available in the eligible retiring employee's sick and special leave accounts after E has credited or contributed the appropriate amounts to such employee's health insurance benefits and section 403(b) and section 457(b) plan accounts.

Section 3101(a) imposes FICA tax "on the income of every individual" in an amount equal to a percentage "of the wages received by him with respect to employment." Section 3111(a) provides that the employer portion of FICA tax is imposed directly upon the employer as "an excise tax, with respect to having individuals in his employ." Similarly, section 3301 provides that FUTA tax is imposed on every employer as an excise tax with respect to individuals in his employ equal to a percentage of wages paid by the employer with respect to employment.

Section 3121(a) provides for FICA purposes and section 3306(b) provides for FUTA purposes, with certain exceptions, that the term "wages" means "all remuneration for employment." Section 3121(a)(5) for FICA purposes and section 3306(b)(5) for FUTA purposes, excludes from the definition of wages certain qualified retirement plans and tax favored annuities.

Wages are generally subject to FICA tax when they are actually or constructively paid. Employment Tax Regulations section 31.3121(a)-2(a). However, in 1983, Congress enacted section 3121(v)(2) which created a special timing rule for amounts paid from a "nonqualified deferred compensation plan."[1]

Section 3121(v)(2) provides that any amount deferred under a nonqualified deferred compensation plan (including a section 457(b) plan) shall be taken into account for FICA purposes as of the later of when the services are performed, or when there is no substantial risk of forfeiture of the rights to such amounts. Section 3121(v)(2)(C) provides that the term "nonqualified deferred compensation plan" means any plan or other arrangement for the deferral of compensation other than a plan

[1]Section 3306(r)(2) applies for FUTA tax purposes and is identical to section 3121(v)(2). The regulations under section 3306(r)(2) cross-reference the regulations under section 3121(v)(2). Accordingly, the analysis and conclusions regarding the timing of FICA taxes are equally applicable to FUTA taxes.

described in section 3121(a)(5). Any amount taken into account as wages by reason of section 3121(v)(2)(A) (and the income attributable thereto) shall not thereafter be treated as wages for FICA tax purposes. Section 3121(v)(2)(B).

Employment Tax Regulations section 31.3121(v)(2)-1(b)(1) defines the term “nonqualified deferred compensation plan” as any plan or other arrangement, other than a plan described in section 3121(a)(5), that is established by an employer for one or more of its employees, and that provides for the deferral of compensation. A plan provides for the “deferral of compensation” with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable in a later year. Regulation section 31.3121(v)(2)-1(b)(3). A nonqualified deferred compensation plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing. Regulations section 31.3121(v)(2)-1(b)(2)(i).

Section 31.3121(v)(2)-1(b)(4) describes plans, arrangements and benefits that do not provide for the deferral of compensation. Specifically, section 31.3121(v)(2)-1(b)(4)(v) provides that benefits provided in connection with impending termination of employment under paragraph (b)(4)(v)(B) or (C) of this section do not result from the deferral of compensation within the meaning of section 3121(v)(2).

Section 31.3121(v)(2)-1(b)(4)(v)(C) provides the following:

> Termination within 12 months of establishment of a benefit or plan. For purposes of this paragraph (b)(4)(v), a benefit is provided in connection with impending termination of employment, without regard to whether it constitutes a window benefit,
> if–
> (1) An employee's termination of employment occurs within 12 months of the establishment of the plan (or amendment) providing the benefit; and
> (2) The facts and circumstances indicate that the plan (or amendment) is established in contemplation of the employee's impending termination of employment.

Since the excess benefit amounts, which are amounts other than amounts paid under the Plan excluded from the definition of wages under sections 3121(a)(5) and 3306(b)(5), are wages as defined in sections 3121(a) and 3306(b), such amounts are subject to FICA and FUTA taxes.

Participation in the Plan is conditioned on the participant’s termination of services. Under the terms of the Plan, employment for the affected participants will terminate within 12 months of establishment of the Plan. The other relevant facts are: (1) the Plan is not yet effective, (2) in order to participate in the Plan and receive excess benefit payments, an employee must agree to retire, or for these purposes "terminate employment," and (3) the date of termination is June 30, 2003, which is less than 12 months away.

Under section 31.3121(v)(2)-1(b)(4)(v), the Plan provides benefits in connection with impending termination, and therefore, the benefits do not result from deferral of compensation. Accordingly, the excess benefit amounts made under the Plan are not made under a nonqualified deferred compensation plan, and the special timing rule of section 3121(v)(2) does not apply.

Based upon the provisions of the Plan summarized above, the documents presented and the representations made, and provided that E's section 457(b) plan constitutes an eligible deferred compensation plan described in section 457(b) and that E's section 403(b) plan constitutes an arrangement described in section 403(b), we conclude as follows:

1. Amounts paid by Employer E under the Plan for the cost of health insurance premiums for retired employees are excludable from the gross income of the retirees pursuant to section 106 of the Code.

2. E's contribution of amounts from the sick and special leave accounts pursuant to the Plan to the eligible retiree's account in E's section 457(b) plan will not cause inclusion of such amounts in his/her taxable income under section 457 of the Code or under the constructive receipt or economic benefit or anticipatory assignment of income doctrine for the year in which the contribution is made.

3. E's contribution of amounts from the sick and special leave accounts pursuant to the Plan to the eligible retiree's account in E's section 403(b) arrangement, which contribution will not cause the employer's yearly contribution on behalf of individuals to exceed the limits of sections 415(c) and 403(b) of the Code, will not cause inclusion of such amounts in his/her taxable income under sections 451 or 457 of the Code or under the constructive receipt or economic benefit [or anticipatory assignment of income doctrine] or for the year(s) in which this contribution is made.

4. Any excess benefits remaining in the eligible retiree's sick and personal leave accounts, after E has made or set aside the appropriate contributions under the Plan to the retiree's health insurance and section 403(b) and section 457(b) plan accounts, will be subject to current income

tax taxation under section 457(f) in the year when the employee retires regardless of whether such excess benefit payments are made in the year when the employee retires or over two or more years.

5. The excess benefit amounts provided to employees under the Plan are wages under sections 3121(a) and 3306(b) and will be subject to FICA and FUTA taxes when actually or constructively paid.

No opinion is expressed concerning the timing of the inclusion in income of amounts deferred or payable under any plan other than E's Plan described above. If the Plan is significantly modified, this ruling will not necessarily remain applicable. This ruling is directed only to Entity E and applies only to the Plan submitted on December 6, 2001, as modified by the revisions submitted on June 21,2002. Section 6110(k)(3) of the Internal Revenue Code provides that this ruling 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 conclusion in the ruling. See section 12.04 of Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 50. However, when the criteria in section 12.05 of Rev. Proc. 2002-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely yours,

ROBERT D. PATCHELL
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Office of the Associate Chief Counsel
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Enclosure:

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