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Legend

City C =

State S =

Employee Sick Leave Plan =

Retiree Sick Leave Plan =

Vacation Leave Plan =

Health Care Plan =

Dear \_\_\_\_\_ :

This responds to your letter of February 10, 2003 and subsequent correspondence, on behalf of City C, located in State S, requesting a ruling concerning the application of sections 451(a) and 457(e)(11) of the Internal Revenue Code (the "Code") to City C's Sick Leave Plan, Retiree Sick Leave Plan, Vacation Plan and Compensatory Time Plan (the "Plans") which City C has established for its eligible employees. In addition, City C has adopted the Health Care Plan, established by State S, for certain units of City C's employees. City C and State S are represented to be eligible governmental employers described in section 457(e)(1)(A) of the Code.

City C has established sick and vacation leave and compensatory time programs providing its employees with paid time off for sick and vacation days. Within limits,

these programs allow employees to accumulate unused sick and vacation leave from year to year. The amendments that City C proposes to make to its plans will not increase the number of sick, vacation, or compensatory days that its employees may earn each year.

### **Employee Sick Leave Plan**

Under the Employee Sick Leave Plan, which is generally applicable to all of City C's employees, an employee may use sick leave only when necessary because of the employee's illness or for other appropriate reasons. City C's employees generally earn 12 days of sick leave a year and may carry over unused sick leave from one year to the next without limitation.

City C proposes to implement the revised Employee Sick Leave Plan to permit any eligible employee to receive a cash payment for unused sick leave before separation from service. Under the revised Plan, each eligible employee who has an unused sick leave balance of not less than 48 or 60 days<sup>1</sup> on December 1 of each year will be eligible to make an election before December 31 of that year (the "Election Year") to receive a cash payment following the end of the next year (the "Accrual Year") for all or a portion of the 12 sick leave days that the employee will earn during the Accrual Year. The employee must make this election by December 31 for it to be valid. An eligible employee who fails to make an election under the Employee Sick Leave Plan on or before December 31 of an Election Year will be deemed to have elected to continue accruing sick leave and will not receive a cash payment before separation from service with respect to sick leave that the employee earns during the Accrual Year. The election will be valid only for sick leave to be earned during the Accrual Year and will not apply to sick leave earned during any prior or subsequent year. Once made, the election will be irrevocable. Within a specified number of days after the end of the Accrual Year, an eligible employee who is employed by City C on the last day of the Accrual Year will be paid a percentage of the employee's daily salary in effect on December 1 of the Accrual Year, multiplied by the number of days of sick leave for which a cash payment is to be made. The percentage will be determined based on the number of days of sick leave the employee has accrued. An employee who makes a timely election and separates from service with City C before the end of the Accrual Year will not be paid cash for sick leave that the employee earned during the Accrual Year unless such employee qualifies for payment under the Retiree Sick Leave Plan described below.

### **Retiree Sick Leave Plan**

Pursuant to the Retiree Sick Leave Plan, when an employee retires from City C, if 1) the employee has an unused sick leave balance of not less than sixty days, 2) the

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<sup>1</sup> Non-bargaining unit employees need at to have least 60 days of accumulated sick leave to make this election whereas collectively bargained employees need to have at least 48 days to make this election.

employee is not a participant in the Health Care Plan described below, and 3) the employee either is disabled or meets one or more specified age and service requirements set out in the Retiree Sick Leave Plan, City C will pay the retiring employee 50% of the employee's daily salary as of the retirement date, multiplied by the number of unused days of sick leave. City C will make the foregoing payment to the beneficiary of an employee who dies while employed by City C, if the deceased employee had more than sixty days of unused sick leave and was not a participant in the Health Care Plan at the time of death. Employees who work in units eligible for the Retiree Sick Leave Plan are not eligible to participate in the Health Care Plan.

### **Vacation Leave Plan**

City C also proposes to revise its Vacation Leave Plan with respect to certain units of its employees as described below. A City C employee is entitled to use vacation leave after obtaining supervisory approval. The number of days of vacation leave a City C employee receives ranges from twelve to twenty-six days per year, depending on his/her seniority with City C and the bargaining unit agreement or regulations applicable to his/her unit of employees. Generally, employees may carry over unused paid vacation time from one year to the next, subject to a specified maximum number of hours. Certain collective bargaining ("CB") units of C's employees have bargained for a CB agreement provision entitling such units' members to elect to receive a cash payment for generally up to forty hours of vacation time that will accrue in the following Accrual Year. City C proposes to implement the revised Vacation Plans to allow CB unit employees to make an election during the Election Year to receive payment after the end of the Accrual Year for the number of vacation hours that were designated by the employee in the election, but not for more than the number of hours earned by the employee during the Accrual Year. For the election to be valid with respect to the Accrual Year, the eligible employee must make it by December 31 of the Election Year immediately preceding the Accrual Year. Once made, the election is irrevocable.

### **Compensatory Time Plan**

City C also proposes to revise its Compensatory Time Plan with respect to certain units of its employees as described below. Employees who work hours in addition to their regularly scheduled hours per week can earn compensatory time. Employees who have earned compensatory time may take paid leave equal to their accrued compensatory time after obtaining supervisory approval. Employees may accumulate up to a specified number of hours of compensatory time. Certain CB units of employees have bargained for a CB agreement provision that, in specified circumstances, requires them to receive a cash payment for a portion of their accumulated unused compensatory time. In each case, pursuant to the CB agreement, the payment is made automatically after the employee has earned a specified number of hours of compensatory time.

## **Health Care Plan**

In addition, City C has adopted the Health Care Plan established and operated by State S to provide certain retired employees of State S and its political subdivisions, such as City C, reimbursement for their post-retirement health expenses as defined in section 213(d) of the Code. For employees who are near retirement and who are members of certain CB or other designated units of City C's employees participating in the Health Care Plan, City C is crediting, on a mandatory basis, 100% of their accrued sick leave benefits at retirement, the percent of their accrued vacation pay at retirement set by the collective bargaining agreement or regulations applicable to the retiring employee's unit, and possibly a percentage of annual salary adjustment set by the collective bargaining agreement or regulations applicable to the retiring employee's unit, to the retiring employees' accounts in the Health Care Plan. Employees who are participants in the Health Care Plan have no right to receive a cash payment for sick leave at retirement or termination of employment, including death.

## **Law and Analysis**

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

Section 451(a) of the Code and § 1.451-1(a) of the Income Tax Regulations provide that an item of gross income is includible in gross income in 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, 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 doctrine of constructive receipt. 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.

In Rev. Rul. 75-539, 1975-2 C.B. 45, a retiring employee could receive a cash payment for accumulated sick leave or elect to have an equivalent amount applied to the cost of accident and health insurance. Citing section 451, the ruling concluded that the value of the unused sick leave time was includible in gross income whether the retiree received such amount in cash or elected to have such amount applied to pay premiums for insurance.

Under the revised Employee Sick Leave and Vacation Plans, the employee will be permitted to make an election before the year in which an employee earns the right to take a period of paid leave. An employee who makes the election will receive a cash payment after the end of such year in lieu of carrying over a specified amount of leave to the next year (or, in the case of vacation leave, forfeiting the amount of such leave that exceeds a specified limit).

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. City C and State S are eligible employers within the meaning of section 457(e)(1)(A).

Section 457(b) of the Code and the regulations thereunder 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 (\$13,000 in 2004) or 100 percent of the participant's includible compensation.

Under section 457(e)(11)(A)(i), a bona fide sick or vacation or compensatory leave plan is treated as not providing for the deferral of compensation for purposes of section 457.

This ruling is based on the facts and circumstances presented for our consideration. Among the factors considered are: 1) that the number of future sick leave days that an eligible active employee could elect to cash out in the next year is not large in relation to the large number of sick leave days that the employee is required to have and maintain in his or her sick leave bank, 2) that those City C employees eligible to elect to cash out a limited portion of their annual leave to be accrued in the next calendar year are in departments providing homeland security-type services to City C subject to possible emergency leave cancellation, 3) that the total number of annual and sick leave days offered by City C to its employees is not excessive in comparison to the number of paid time off days offered by other governmental employers, 4) that the programs are broad-based, generally being offered either to virtually all City C employees or to all employees in certain units or departments, and 5) that the plans described in this letter are not constructed in such a way as to provide a compelling reason for the employees to convert the leave time to another use. Based on these factors, we conclude that, in this case, the primary purpose of City C's program for the crediting and use of sick, vacation and compensatory time under its leave plans (including the proposed revised plans) is to provide employees with paid time off from work when appropriate because of sickness, vacation or for other personal reasons. Thus, the sick, vacation and compensatory time leave programs are part of a bona fide

sick, vacation, or compensatory leave plan within the meaning of section 457(e)(11). Accordingly, the rules of section 457 do not apply to these leave plans of City C.

Based on the facts and representations submitted, and provided that all elections under the revised Sick Leave and Vacation Plans are (i) irrevocable and (ii) made before the end of the calendar year preceding the calendar year in which the electing employee earns the right to take the paid leave that is the subject of the election, we rule as follows:

(1) Under the doctrine of constructive receipt and section 451, the right of a City C employee to make an election either to continue accruing sick leave or to cash out all or part of the sick leave that will be earned in the next year under the Employee Sick Leave Plan does not result in taxable income for the employee under the cash receipts and disbursements method of accounting.

(2) Under the doctrine of constructive receipt and section 451, a City C employee's election under the Employee Sick Leave Plan to cash out all or part of the employee's sick leave that will be earned in the next year does not result in taxable income to the employee, under the cash receipts and disbursements method of accounting, until the year in which the amounts are actually paid or otherwise made available.

(3) Under the doctrine of constructive receipt and section 451, the right of a City C employee to make an election either to continue accruing vacation leave or to cash out all or part of the vacation leave that will be earned in the next year under the Vacation Plan does not result in taxable income to the employee under the cash receipts and disbursements method of accounting.

(4) Under the doctrine of constructive receipt and section 451, a City C employee's election under the Vacation Plan to cash out all or part of the employee's vacation leave credit that will be earned in the next year does not result in taxable income to the employee, under the cash receipts and disbursements method of accounting, until the year in which the amounts are actually paid or otherwise made available.

(5) Under the doctrine of constructive receipt and section 451, a City C employee's right to receive cash for accumulated compensatory time in excess of a specified number of hours does not result in taxable income to the employee, under the cash receipts and disbursements method of accounting, until the year in which the amounts are actually paid or otherwise made available.

(6) The Vacation Plan, the Employee Sick Leave Plan, the Retiree Sick Leave Plan, and the Compensatory Pay Plan are bona-fide vacation leave, sick leave and compensatory time leave plans described in section 457(e)(11)(i) and are, therefore, not subject to section 457(a) or section 457(f).

Except as specifically ruled on above, no opinion is expressed or implied concerning the federal tax consequences of the above transactions under any other provision of the Code, such as section 106 relating to the income tax treatment of employer reimbursements of medical care expenses. If any of the leave plans described above is not implemented as proposed or if any of these Plans is further modified, this ruling may not necessarily remain applicable. This ruling is directed only to City C and applies only to the latest version of the revised Plans submitted to the Internal Revenue Service. 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 will be modified or revoked by the adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 11.04 of Rev. Proc. 2004-1, 2004-1 I.R.B. 1, 46. However, when the criteria in section 11.06 of Rev. Proc. 2004-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent as requested.

Sincerely,

Robert D. Patchell  
Branch Chief, Qualified Plans 2  
Office of Division Counsel  
(Tax Exempt & Government Entities)

Enclosure (1)  
Copy of this letter for section 6110 purposes

cc: