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September 28, 2001

Entity E =

Dear

This responds to your letter of July 14, 2000 and subsequent correspondence, on behalf of Entity E, requesting a ruling concerning the application of the constructive receipt of income doctrine and section 403(b) of the Internal Revenue Code (the "Code") to the revised paid-time-off (PTO) plan and policy (the "Plan") that E intends to implement for its eligible employees in the near future. E is represented to be a tax exempt entity that is an eligible employer described in section 457(e)(1)(B) of the Code. In addition, E sponsors a tax sheltered annuity arrangement described in section 403(b) of the Code providing for elective deferrals for its employees.

E has a pre-existing flexible leave program providing qualified members of its staff (all full-time employees and certain part-time employees) with paid time off for vacations, holidays, personal days and sick days, including extended periods of illness. The revised Plan permits an eligible employee of E to irrevocably elect, generally by December 1 of the current year, one of three options concerning a limited number of PTO hours (established by the Plan) to be earned in the next calendar year: (l) to take those hours off as paid leave in the next year, (2) to contribute the cash equivalent of those PTO hours to the employee's account as elective deferrals in E's section 403(b) plan during the next year, or (3) to receive the cash equivalent of those PTO hours as additional compensation during the next year. The eligible employee may also elect to take any combination of these three options with respect to those designated PTO hours. A newly eligible participant may file an election for the remainder of the current calendar year (following that election) within 30 days of becoming eligible for participation in the first year when he becomes eligible.

These designated PTO hours are required to be applied in the calendar year following the year when the election is made, in one or more of these three ways. If an employee fails to make a timely election, the Plan provides a default election regarding those designated PTO hours since this program is mandatory for all employees eligible for PTO.

It is represented that the revised Plan will not provide E's employees any additional hours of PTO that they had not already been entitled to under the previous PTO plan and policy which had not included this election.

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 exclusion allowance for such taxable year.

Section 415(c) of the Code states that the limits on the amounts of annual additions 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) $30,000 (or, if greater, ¼ of the dollar limitation in effect under section 415(b)(1)(A)), or (B) 25 percent of the participant's compensation.

Sections 402(g)(1) and (3) of the Code impose a limit on the annual dollar amount of elective deferrals made by a participant in the year. Section 402(g) limits the elective deferrals in a 403(b) plan to no more than $9,500 a year (as adjusted for cost of living).

Section 403(b)(2)(A) of the Code provides, in part, for an exclusion allowance for any employee for the taxable year in an amount equal to the excess, if any, of (i) the amount determined by multiplying 20 percent of his includible compensation by the number of years of service, over (ii) the aggregate amounts contributed by the employer for annuity contracts and excludible from the gross income of the employee for any prior taxable year.

Section 403(b)(3) of the Code defines "includible compensation," in part, as the amount of compensation which is received from the employer and which is includible in gross income (computed without regard to section 911) for the most recent period (ending not later than the close of the taxable year) which may be counted as one year of service under section 403(b)(4).

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) as a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state, or any other organization (other than a governmental unit) exempt from tax under subtitle A of Title 1 of the Code. E is an eligible employer within the meaning of section 457(e)(1).

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 vacation leave (including the proposed revision for the leave program) is to provide employees with paid time off from work when appropriate because of sickness or for other personal reasons. Thus, the PTO Plan (including the proposed revision) is 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 pursuant to the revision of the PTO Plan will result in a deferral of compensation. Accordingly, the rules of section 457 do not apply to the PTO Plan (including the proposed revision).

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.

Under the proposed revision to the PTO Plan, the employee's election to take part or all of the mandatory PTO available for options as cash compensation in the following calendar year, as paid time off in the following calendar year or as includible compensation for an elective deferral to the tax sheltered annuity in the following calendar year, is made before the beginning of the period of service for which the compensation is payable. No amount is constructively received by an employee when the employee makes an irrevocable election in December, selecting one or more of the three options available concerning a limited number of PTO hours to be earned in the next calendar year, because once the employee earns the PTO hours, the employee cannot elect to receive any amount in cash in lieu of the other PTO options provided on account of unused leave.

Based upon the provisions of the Plan summarized above, and the documents presented, we conclude as follows:

1. An employee's election, properly made under the Plan before the deadline established thereunder, to take part or all of the mandatory

qualified PTO available for options as cash compensation in the following calendar year or as paid time off in the following calendar year will not cause inclusion of such amounts in his taxable income under either the doctrine of constructive receipt of income or section 457 of the Code for the year in which this election is made.

2. Under Entity E's leave accrual system, the cash equivalent of PTO is income received for the most recent one-year period of service, ending not later than the close of the taxable year. Accordingly, the election to use the cash equivalent of PTO to enhance includable compensation for an elective deferral to the tax sheltered annuity, which contribution will not cause employers' year contribution on behalf of individuals to exceed the limits of sections 415, 402(g) and 403(b) of the Code, will not be includible in gross income by reason of that election.

No opinion is expressed concerning the timing of the inclusion in income of amounts deferred or payable under any plan other than E's revised PTO Plan and Policy 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 revised Plan submitted on October 9, 2000. 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. 2001-1, 2001-1 I.R.B. 1, 46.

However, when the criteria in section 12.05 of Rev. Proc. 2001-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely yours,
ROBERT D. PATCHELL
Acting Chief, Branch 1
Office of the Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure:
Copy for section 6110 purposes