**Internal Review Service** Department of the Treasury

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Legend

Entity E =

Dear :

This responds to your letter of October 2, 2001 and subsequent correspondence, on behalf of Entity E, requesting a ruling concerning the application of sections 403(b), 451(a) and 457 of the Internal Revenue Code (the "Code") to E's Unused Sick Leave Conversion 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.

Under two programs, one for its rank-and-file employees and another for its administrators, E provides sick leave benefits to its employees. E's employees are permitted a set number of paid days of sick leave annually and, subject to limits set by the plans, can accumulate any unused sick days in their sick leave account from year to year. You have represented that E intends to adopt the Sick Leave Conversion Plan (the "Plan") that will provide eligible employees of E who retire in accordance with E's retirement policy either with supplemental health benefits or with a contribution to their accounts in E's section 401(a) and section 403(b) plans. The conversion of leave would be calculated under a formula E establishes which will assign a dollar value to the sick days. The Plan does not provide E's employees with any election of the form of benefits to be provided.

Under the Plan, E will make contributions, measured by the value of the retiring employee's accumulated unused sick leave to one of the following supplemental benefits prior to an employee's retirement: (1) additional medical coverage which will commence after the lapse of the retiree health insurance provided by E and which will continue until the retiree's converted sick leave is exhausted or (2) contributions to a section 401(a) plan or section 403(b) account in the employee's name which will begin on the date of the employee's retirement. E's contribution to either the supplemental

medical benefit or the retirement plan will be based on several factors including the retiring employee's access to other health insurance coverage, the value of the retiring employee's unused accumulated sick leave, and the willingness of E's insurance carrier to cover retired employees. At no time does the retiring employee have a choice of contributions to the supplemental medical benefit or the deferred compensation plan.

E represents that it understands that the section 401(a) plan is a qualified plan described in section 401(a) and that its section 403(b) arrangement is an arrangement described in section 403(b). E also represents that it will make contributions to the employee's account in the section 401(a) plan or section 403(b) arrangement only up to the appropriate statutory limitations.

E has previously received a ruling from the Internal Revenue Service that its contributions to the Plan to provide supplemental medical benefits to retiring employees are excludable from a retiring employee's gross income under section 106 of the Code. We have been asked to determine whether section 457 of the Code applies to any of the benefits provided under E's sick leave conversion plan.

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 non-forfeitable 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 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 plans for the crediting and use of sick and emergency leave is to provide employees with paid time off from work when appropriate because of sickness or for other personal reasons. Thus, the sick leave and

emergency leave programs are part of a bona fide sick or vacation leave plan within the meaning of section 457(e)(11), notwithstanding that the contributions made under the Plan to E's tax sheltered annuity arrangement and qualified retirement plans pursuant to the Plan will result in a deferral of compensation. Accordingly, the rules of section 457 are not applicable to E's sick leave programs.

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) does not apply in this case to the amounts contributed to the employee's account in the supplemental health benefit or retirement plan. The amounts credited to the retiring employee's health benefits account are excluded from his income under section 106, as noted in the ruling you previously received, and do not constitute deferred compensation subject to section 457(f). Although the amounts properly contributed to the employee's section 401(a) and section 403(b) plan accounts constitute deferred compensation, they are excluded from the application of section 457(f) under sections 457(f)(2).

Based upon the provisions of the Plan summarized above, the documents presented and the representations made, and provided that E's sick leave and emergency leave programs are modified to incorporate the Plan's provisions, that E's section 401(a) plan constitutes a qualified retirement plan described in section 401(a) and that E's section 403(b) plan constitutes an arrangement described in section 403(b), and that E's contributions to the employees' accounts in their retirement plan accounts comply with the appropriate statutory limitations, we conclude as follows:

1. E's contribution of amounts from the sick leave and emergency leave programs pursuant to the Plan to the eligible retiree's account in E's section 401(a) plan or section 403(b) arrangement 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 doctrine for the year in which the contribution is made.

2. The Plan's provision that provides E the option to contribute the amounts available to the retiree under the sick leave programs for either the retiree's supplemental health benefits or retirement plan account does not make the value of the medical benefit taxable to the retiring employee under the anticipatory assignment of income doctrine.

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 sick leave conversion plan described in the taxpayer's submission. 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
Chief, Qualified Plans Branch 2
Office of the Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure:

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