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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Uniform Issue List: 401.00-00

AUG 26 2002

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T:EP:RA:T2

Attn: **********

Legend
Employer M = **********
Agreement A = **********
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Local A = **********
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Plan X = **********
Group B Employees = **********

Dear **********

This letter is in response to your request for a private letter ruling which was dated June 5, 2000, and supplemented by correspondence dated June 6, 2000, August 21, 2000, and August 22, 2000, which was submitted on your behalf by your authorized representative. You request rulings concerning the federal income tax consequences of an eligible employee's exchange of up to five days of unused sick leave in exchange for a contribution to Plan X.

The following facts and representations have been submitted on your behalf:

Employer M is an organization exempt from federal income tax under section 501(c)(3) of the Code. Effective January 1, 2000, Employer M established Plan X for the benefit of its eligible union and nonunion employees. Plan X is a discretionary defined contribution plan with a salary deferral feature. Although Employer M also maintains a defined benefit plan for its eligible employees, only Plan X is the subject of this ruling. Both plans are designed to meet the

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requirements of section 401(a) of the Internal Revenue Code and are subject to the nondiscrimination requirements set forth in section 401(a)(4) of the Code.

Employer M employs both union and nonunion employees. The union employees are represented by Local A. Employer M and Local A entered into Agreement A covering the period from 1999 through 2002. Accrual and usage of sick leave is covered in Section of Agreement A, which provides, in part, as follows:

Under Agreement A, a union employee working after June 30, 1996, will generally earn 12 days of sick leave each year. The employee may use these days for illness, injury or doctor's and dental appointments. The employee may accumulate up to 90 unused sick leave days; sick leave in excess of 90 days is forfeited.

Neither an active employee, a terminated employee nor a retiree hired after June 30, 1996, may receive cash in lieu of unused sick leave. An employee hired before July 1, 1996, is entitled to a cash payment based on unused sick leave if the employee remains with Employer M until retirement under the provisions of Agreement A, but the amount of the cash payment

cannot exceed 100 percent of the retiree's regular daily rate of pay immediately prior to retirement multiplied by 30 percent of the retiree's accrued sick leave as of June 30, 1996.

Employer M also provides a death benefit to the surviving beneficiary of a union employee who dies while working for Employer M, and the amount of this benefit is based on the decedent's accumulated sick leave at the date of death.

The last provision of Section of Agreement A states that, subject to the receipt of a favorable private letter ruling from the Internal Revenue Service:

> (a) Employees who have accrued days of sick leave may elect to contribute up to days of unused sick leave to the employer's qualified defined contribution plan at the rate of percent ( ) of the employee's regular gross pay for the days. Such contributions shall be on a pre-tax basis and are subject to section 415 limits and applicable nondiscrimination rules as defined by ERISA, the IRS and applicable law.
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> (b) All contributions made by Group B Employees to Plan X are the property of the Group B Employees and transfer to the Group B Employees upon separation from employment.

In compliance with this portion of Agreement A, Employer M proposes to implement the Sick Leave Exchange program that will permit employees who have accumulated 30 days of sick leave to elect to contribute up to five days of unused sick leave to Plan X at the rate of 20 percent of the employee's regular gross pay. The employee would be fully vested at all times in the contributions made to Plan X under the Sick Leave Exchange.

Based on the foregoing facts and representations, you have requested the following rulings:

1. Under Code section 451, the proposed Sick Leave Exchange program permitting the exchange of up to five days of unused sick leave for Employer M's contribution to Plan X will not result in actual or constructive receipt of income to any employee of Employer M who has accumulated sufficient sick leave days and is otherwise eligible to participate in the program.

2. The proposed contribution by Employer M to Plan X on behalf of a Group B Employee who has elected to exchange up to five days of unused sick leave is not a contribution made pursuant to a salary reduction agreement within the meaning of Code section 401(k)(2)(A) and section 1.401(k)-1(a)(3)(i) of the Income Tax Regulations. Rather,

Employer M's contribution to Plan X in exchange for unused sick leave is a nonelective employer contribution.

3. The proposed contribution by Employer M to Plan X pursuant to an employee's election under the Sick Leave Exchange program is not includible in the employee's gross wages for purposes of the Federal Insurance Contributions Act ("FICA") under Code section 3121.

Section 451 of the Code and Treas. Reg. § 1.451-1(a) provide that under the cash receipts and disbursements method of accounting, an amount is includible in gross income when actually or constructively received. Treas. Reg. § 1.451-2(a) provides that income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer or otherwise made available so that the taxpayer may draw upon 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.

Currently, employees may accumulate up to 90 days of unused sick leave; unused sick leave in excess of 90 days is forfeited. Employees (or their beneficiaries) hired before June 30, 1996, may receive cash (based on a formula set forth in Agreement A) in lieu of unused sick leave if they die while employed by Employer M or if they retire. Employees hired after June 30, 1996, and employees hired before that date but who terminate employment other than by death or retirement are not entitled to receive payment for accumulated but unused sick leave.

In this proposed transaction, unused accumulated sick leave will be used by the employee as needed, accumulated for future use, exchanged for a contribution to the Plan, or forfeited if the number of unused days exceeds 90. The Sick Leave Exchange program does not give eligible employees the right to receive payment for unused sick leave. A contribution to an employee's account under Plan X as a result of the Sick Leave Exchange program is not income credited to the taxpayer's account under Treas. Reg. § 1.451-2(a). Therefore, with respect to ruling request number one, we conclude that the proposed exchange will not result in actual or constructive receipt of income under section 451 of the Code by an eligible employee.

In ruling request number two, you have requested a ruling that the proposed contribution by Employer M to Plan X on behalf of the Group B Employee who has elected to exchange up to five days of unused sick leave is not a contribution made pursuant to a salary reduction agreement within the meaning of Code section 401(k)(2)(A) and section 1.401(k)-1(a)(3)(i) of the Income Tax Regulations. Rather, Employer M's contribution to Plan X in exchange for unused sick leave is a nonelective employer contribution.

Section 401(k)(2)(A) of the Code 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) of the Income Tax Regulations 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) of the Income Tax Regulations 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 contribution as (A) any employer contribution (including a contribution 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 the Sick Leave Exchange proposal, an employee who becomes entitled to 12 days of sick leave during the year will first be able to use these days for appropriate sick leave purposes; if the employee does not use all of these days and the employee has at least 30 and less than 90 days of accumulated sick leave days, the employee would be able to either (a) add all of the unused days to the employee's accumulated sick leave (up to a maximum of 90 days), or (b) exchange up to five of the unused days for a contribution by Employer M to Plan X and accumulate the remainder, if any. Once an employee has 90 days of accumulated sick leave, the employee's only options for additional unused sick leave would be to either (a) forfeit the additional leave, or (b) exchange up to five days of the unused sick leave for a contribution by Employer M to Plan X. In either case the employee's current cash compensation would not

be affected by the choices because the Sick Leave Exchange program does not give eligible employees the right to receive payment for unused sick leave.

Because the Group B Employee will not have the option to receive additional cash or any other taxable benefit in lieu of additional Plan X contributions, the choice between the two options discussed above is not a cash or deferred election. Therefore, in view of the foregoing, we conclude with respect to ruling request number two that the contribution to Plan X in exchange for unused sick leave is a nonelective employer contribution rather than a cash or deferred election.

With regards to ruling request number three, section 3121(a)(5)(A) provides in general that the term "wages" shall not include any payment made to, or on behalf of, an employee or his beneficiary from or to a trust described in section 401(a) of the Code. However, section 3121(v)(1)(A) states that "wages" includes any employer contribution under a qualified cash or deferred arrangement (as defined in section 401(k)) to the extent the contribution was not included in the employee's gross income under section 402(3)(e).

In the proposed transaction, amounts contributed by Employer M to Plan X pursuant to Group B Employees' election under the Sick Leave Exchange is a nonelective employer contribution and not a contribution under a qualified cash or deferred arrangement (as defined in section 401(k)). Therefore, the general rule under section 3121(a)(5)(A) of the Code applies, and we conclude that the proposed contribution by Employer M to Plan X pursuant to Group B Employees' election under the Sick Leave Exchange program is not includible in the employee's gross wages for FICA purposes under Code section 3121.

Except as specifically ruled on above, no opinion is expressed as to the federal tax consequences of the above transaction under any other provision of the Code.

This letter expresses no opinion as to whether Plan X satisfies the requirements for qualification under section 401(a) of the Code. The determination as to whether a plan is qualified under section 401(a) is within the jurisdiction of the appropriate Area Office of the Internal Revenue Service.

This ruling is directed only to the taxpayer who requested it and applies only to Plan X as proposed in this ruling. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

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A copy of this ruling has been sent to your authorized representative in accordance with a Power of Attorney on file in this office. If you have any questions regarding this letter, please contact **********, T:EP:RA:T:2 at **********.

Sincerely yours,

Joyce E. Floyd

Joyce E. Floyd, Manager
Employee Plans Technical Group 2
Tax Exempt and Government Entities Division

Enclosures:
Deleted copy of this letter
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