Internal Revenue Service
memorandum

date: MAY 29 1997

to: Carol Gold, Director
Employee Plans Division, CP:E:EP

from: Mary Oppenheimer, Assistant Chief Counsel
CC:EBEO

Mary Oppenheimer

subject: [redacted] Technical Advice Request

1. <u>Overview</u>

You requested technical assistance from us on whether funds contributed to the [redacted] for Employees (the "Plan") that are based on unused vacation time are considered nonelective employer contributions or employee contributions for purposes of section 3121(a) of the Internal Revenue Code (the "Code"). A Technical Advice Memorandum was issued on November 9, 1995, which concluded that the contributions were employer nonelective contributions and that Social Security and Medicare taxes under section 3121(a) did not apply to the nonelective contributions. [redacted]

In brief, our conclusion remains that the contributions to the Plan that are based on unused vacation time are nonelective employer contributions as defined in section 1.401(m)-1(f)(13) of the Treasury Regulations (the "Regulations"). Because the Vacation Pay Benefit is a nonelective employer contribution, the amount contributed is exempt from FICA tax liability under section 3121(a)(5)(A) of the Code. Further, the distribution of the Vacation Pay Benefit from the Plan to the participant is exempt from FICA liability under section 3121(a)(5)(A).

2. <u>Facts</u>

The Plan, established by [redacted] ([redacted]), is a stock purchase plan with cash or deferred arrangements, matching contributions and employee after-tax contributions. In addition, eligible employees who chose not to take all of their paid annual leave can elect to have some or all of their vacation time, in excess of [redacted] weeks, converted to an equivalent dollar amount and deposited in the Plan (the "Vacation Pay Benefit").[1] The

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[1] [redacted] employees are entitled to a certain amount of paid annual leave based on years of service. An eligible employee is

converted funds are invested in [redacted] common stock. At no time does an employee have the right to elect to receive cash directly in lieu of the vacation time. Because there is no option to receive any amounts in cash, you have determined that this arrangement, as it relates to vacation pay, is not a cash or deferred arrangement.

3. Plan Provisions

Section [redacted] of the Plan provides that an employee will receive a Vacation Pay Benefit if the employee (a) is eligible to take more than [redacted] weeks of paid vacation, (b) had advised his supervisor in writing not later than the immediately preceding December 31 of the amount of earned vacation in excess of [redacted] weeks that he would not take in the following year, and (c) had not taken any of the vacation that he had indicated would not be taken except for unanticipated reasons and with the approval of the Employee's supervisor. Section [redacted] of the Plan provides that the Vacation Pay Benefit shall be calculated by adding (a) the employee's regular weekly rate of salary or wage (determined as of the December 31 as of which eligibility is determined) and (b) an amount equal to the sum of commissions, incentive bonuses, premiums, overtime and shift differentials actually paid to the Participant during the calendar year in which eligibility is determined, multiplied by a fraction the numerator of which is one and the denominator of which is fifty-two. This total is multiplied by the lesser of (a) the vacation time in weeks that the Participant originally elected not to take or (b) the vacation time in weeks in excess of two weeks actually not taken.

Section [redacted] of the Plan provides that the amount of the Vacation Pay Benefit shall be contributed by the Employer out of current or accumulated earnings as soon as practicable after the December 31 as of which the amount is determined. The contributions shall be invested in [redacted] common stock and credited to the Participant's account for the Program Year. The Vacation Pay Benefit is not forfeitable, and it will be distributed on the same basis as a Regular Contribution by the Participant. A Vacation Pay Benefit cannot be withdrawn until a date that is [redacted] months after the date on which the Vacation Pay Benefit was paid to the Trustee.

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defined in Section [redacted] of the Plan as an employee who has attained age 18 and who is not a leased employee within the meaning of section 414(n)(2) of the Code.

The Vacation Pay Benefit provision was effective [redacted] and was eliminated effective [redacted]

4. Characterization of Vacation Pay Benefit

There are basically four types of permitted contributions to a qualified profit sharing plan: (1) an elective deferral under a cash or deferred arrangement, (2) a matching contribution, (3) a nonelective employer contribution or (4) an employee after-tax contribution. As discussed below, the Vacation Pay Benefit is a nonelective employer contribution.

A. Vacation Pay Benefit Is Not an Elective Deferral or a Matching Contribution

Although the employee makes an election to forego his or her vacation in order to receive the Vacation Pay Benefit contribution, this election is not a cash or deferred election as defined in section 401(k) of the Code. Section 401(k)(2)(A) defines a cash or deferred arrangement as any arrangement which is part of a profit sharing plan under which an 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)-1l(a)(3)(i) defines a cash or deferred election as 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 under a plan deferring the receipt of compensation.

Under the Plan, an employee's only options with respect to vacation time entitlement in excess of two weeks per year are (1) to take the vacation time; (2) to have [redacted] contribute the value of the time to the Plan; or (3) to forfeit the vacation time and not receive a contribution to the Plan. For example, suppose an employee is entitled to four weeks vacation and compensation of $1,000 per week. Under option (1), the employee would work 48 weeks and be paid $52,000. Under option (2), the employee could work 50 weeks. The employee would still receive $52,000 in cash compensation but the employer would also contribute $2,000 to the Plan for the two weeks of unused vacation time. Under option (3), the employee could work up to 52 weeks and would receive $52,000 in cash compensation, but would not receive a contribution by the employer to the Plan. The employee does not have the option to receive cash or another taxable benefit in lieu of the additional employer contribution to the Plan, therefore, the employee's election is not a cash or deferred election and the Vacation Pay Benefit contribution to the Plan is not an elective deferral.

The Vacation Pay Benefit is not a matching contribution as defined in section 401(m) because the Vacation Pay Benefit is not contributed to the employee's account under the Plan on account of either an elective deferral or an employee contribution.

B. Vacation Pay Benefit Is Not an <u>After-Tax Employee Contribution</u>

[redacted] The Regulation defines the term employee contribution as any mandatory or voluntary contribution to the plan that is treated at the time of contribution as an after-tax employee contribution (e.g., by reporting the contribution as taxable income subject to applicable withholding requirements) and is allocated to a separate account to which the attributable earnings and losses are allocated.

[redacted] did not treat the Vacation Pay Benefit as an after-tax employee contribution at the time the Benefit was contributed to the Plan or at any subsequent time. Neither the Code nor the related Regulations require that [redacted] treat the Vacation Pay Benefit as an employee contribution in order to use it for 401(m) testing purposes. Rather, section 401(m)(3) provides that an employer may elect to take into account in computing the contribution percentage qualified nonelective contributions under a plan. The use of nonelective contributions for purposes of section 401(m) testing does not convert nonelective contributions into employee contributions. Therefore, the Vacation Pay Benefit should not be treated as an employee contribution. However, as discussed below, [redacted] may have erred in testing the Vacation Pay Benefit under section 401(m).

C. Vacation Pay Benefit Is a <u>Nonelective Employer Contribution</u>

The Vacation Pay Benefit is a nonelective employer contribution under section 1.401(m)-1(f)(13) of the Regulations. These regulations do not define the term, but rather reference the definition of nonelective contribution under section 401(k). Section 1.401(k)-1(g)(10) defines a nonelective contribution as an employer contribution (other than a matching contribution) with respect to which the employee may not elect to have the contribution paid to the employee in cash or other benefits instead of being contributed to the plan.

As discussed above, the Vacation Pay Benefit contribution is not made pursuant to a cash or deferred arrangement because the employee cannot elect to receive cash equal to the value of the unused vacation time rather than to receive the Benefit. Further, the Vacation Pay Benefit is not made on account of either an employee contribution to the Plan or an elective deferral for the employee; therefore, the Vacation Pay Benefit is not a matching contribution as defined in section 1.401(m)-1(f)(12)(i) of the Regulations. The Vacation Pay Benefit does not fit within either exception, and, therefore, is classified as a nonelective contributions.

5. Application of Section 3121(a) of <u>the Code to the Vacation Pay Benefit</u>

FICA taxes are imposed on "wages," which is defined in section 3121(a) of the Code as all remuneration for employment unless specifically excepted.

Section 3121(a)(5)(A) excepts from the definition of wages any payment made to, or on behalf of, an employee or his beneficiary --

> from or to a trust described in section 401(a) which is exempt from tax under section 501(a) at the time of such payment unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust.

Section 3121(v)(1)(A) provides that nothing in any paragraph of subsection (a) (other than paragraph (1)) shall exclude from the term "wages" any employer contribution under a qualified cash or deferred arrangement (as defined in section 401(k)) to the extent not included in gross income by reason of section 402(e)(3).

Accordingly, the application of FICA to contributions to a trust described in section 401(a) which is exempt from tax under section 501(a) depends upon whether the contributions are (1) elective contributions made pursuant to a qualified cash or deferred arrangement or (2) nonelective contributions that are not made under a qualified cash or deferred arrangement.

Carol Gold, Esq.
Director, Employee Plans Division

[redacted] We conclude that the Vacation Pay Benefit is an employer nonelective contribution. Therefore, the Vacation Pay Benefit is not wages subject to FICA taxes pursuant to section 3121(a)(5)(A). Further, distributions of the Vacation Pay Benefit from the Plan are not wages subject to FICA taxes pursuant to section 3121(a)(5)(A).

6. Testing of the Vacation Pay Benefit[2]

A. Testing under Section 401(m)

The original request for technical assistance stated that [redacted] tested the Vacation Pay Benefit as a nonelective contribution under section 401(m) of the Code. The Vacation Pay Benefit was included in the total amount entitled "incentive and/or vacation" benefits. During the audit, [redacted] separated the amounts and excluded the Vacation Pay Benefit to show that section 401(m) was satisfied whether the Vacation Pay Benefit was included or excluded.

Although the Vacation Pay Benefit is a nonelective contribution, it does not meet the requirements for a "qualified nonelective contribution" for purposes of section 401(m) testing. Section 401(m)(4)(C) of the Code requires, in part, that qualified nonelective contributions meet the requirements of subparagraphs (B) and (C) of section 401(k)(2). Section 401(k)(2)(C) of the Code requires that elective deferrals be nonforfeitable. Section [redacted] of the Plan provides that Vacation Pay Benefit is nonforfeitable. Therefore, the Vacation Pay Benefit meets one of the requirements for a qualified nonelective contribution.

The Vacation Pay Benefit does not, however, meet the requirements under section 401(k)(2)(B) of the Code. Section 401(k)(2)(B) provides that distributions of elective deferrals

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[2] Technical advice was requested only with respect to the treatment of the Vacation Pay Benefit under section 3121(a) of the Code. However, upon reviewing the information we received from the Key District Office, we feel that [redacted] may have incorrectly tested the Benefit under section 401(m) of the Code. Therefore, the testing of the Vacation Pay Benefit is addressed in this memorandum.

can only occur upon (I) the participant's separation from service, death or disability, (II) certain distributions upon the termination of the plan or the disposition of the assets of the corporation, (III) the participant's attainment of age 59 ½, and (IV) certain hardships of the participant. Section [redacted] of the Plan provides that the Vacation Pay Benefit shall be distributed on the same basis as a Regular Contribution made by the Participant. Further, a Vacation Pay Benefit shall not be withdrawn until a date that is [redacted] months after the date on which the Vacation Pay Benefit was made to the Trustee. Section [redacted] of the Plan provides that a participant may elect at any time during the year to receive a distribution from his accounts in the following order:

1. Employee Additional Contribution accounts;
2. Employee Regular Contribution accounts which have matured (i.e., vested);
3. Employer contribution accounts which have matured;
4. The participant's matured vacation pay account;
5. The participant's matured incentive pay account;
6. Employee Regular Contribution accounts which have not matured.

Section [redacted] provides that notwithstanding the order of distribution set forth above, a participant may elect to receive a cash distribution from a Vacation Pay Benefit account provided such election is made within [redacted] days prior to the maturity of the Vacation Pay Benefit. Although the Plan is poorly drafted, it appears that a participant has the right, at the very least, to withdraw the amount of the Vacation Pay Benefit [redacted] years after it was contributed to the Plan. This right violates the distribution restrictions under section 401(k)(2)(B). Therefore, the Vacation Pay Benefit does not satisfy the requirements for qualified nonelective contributions and cannot be used for Plan testing under section 401(m) of the Code.

B. Testing under Section 401(a)(4)

The nonelective contributions must instead be tested under the nondiscrimination provisions under section 401(a)(4) of the Code. The Vacation Pay Benefit would not meet the requirements for either of the safe harbor tests under section 1.401(a)(4)-2(b) of the Regulations for plans with a uniform allocation formula or plans with a uniform points allocation formula. The Vacation Pay Benefit would have to be tested under either the general test set forth in section 1.401(a)(4)-2(c) of the Regulations or cross-tested under section 1.401(a)(4)-8(b) of the

Regulations. The Vacation Pay Benefit would also have to pass the participation requirements under section 410(b) of the Code.