

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
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X =
Plan =

Employees =

This is in response to your request for a ruling for X, a municipality, regarding the cashout of future vacation leave under the Plan by employees of X. Vacation leave is earned on a monthly basis on the first day of each month. Employees may carry over unused vacation hours into following years, subject to maximum limitations. Within a calendar year, employees are allowed to accrue vacation hours beyond the maximum limits only if used within that year. Employees with unused vacation time on the date of their separation from service receive a cash distribution equal to the number of hours of unused vacation leave multiplied by their then current rate of pay.

X has entered into a collective bargaining agreement with certain bargaining unit employees. Under the terms of the agreement, employees will be allowed to cash out some excess vacation hours prior to separation from service under the terms of the Plan. Under the Plan, an employee would have an opportunity to elect irrevocably at any time on or before December 31st of each year to receive cash for part or all of the amount of vacation hours that would otherwise accrue in the immediately following six month period, but not to exceed 40 hours for each six month period. For example, in Year 1, an eligible employee can irrevocably elect to receive payment for 40 hours that will be earned from January 1 through June 30, Year 2, and payment for another 40 hours that will be earned from July 1 through December 31, Year 2. To be eligible to make the election, the employee must have at least 56 hours of accrued but unused vacation leave to carryover to the year in which the vacation is cashed out. Any vacation time actually taken by the employee will be subtracted first from any carryover hours which existed at the end of the prior year and then from vacation hours accrued in the current year for which no election has been made. The election shall be made by

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filing a written notice with X. The election is only valid for one year, therefore, an employee must make a new election by December 31st with respect to vacation accrued during the next calendar year. The election is irrevocable, and the employee can neither increase (if fewer than 40 hours were originally to be paid out) nor decrease the number of hours for which payment will be made.

In addition, any employee who has both completed at least 16 years of service with X and who has also reached the maximum number of carryover vacation hours may, in lieu of the election discussed above, elect at any time on or before December 31st of any eligible year to receive payment for all vacation hours that would otherwise accrue in a defined 36 consecutive month period (the "increased pay period"), starting as of the first of the month in the following year and continuing for 36 months. The employee must meet both the service and maximum hours requirements at the time the election is made. The foregone vacation hours would be valued and paid out monthly at the hourly rate then-applicable to the employee during each month. This election can be exercised only once during an employee's career. If an employee who has made this election continues in service after the end of the initial 36-month period, the employee can irrevocably elect before the end of the first increased pay period to extend the election for up to an additional 36 consecutive months. This extension would be allowed only once. The only paid vacation time available to an employee during the increased pay period would be from vacation hours accrued before and carried over to the increased pay period. The employee can elect to discontinue payment of vacation earned during the increased pay period. This election would apply beginning on January 1 of the following year during the increased pay period. The election to discontinue the cash-out of foregone vacation hours is irrevocable for the remainder of the employee's service with X.

Section 451(a) of the Internal Revenue Code and section 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 section 1.451-2(a) of the regulations, 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.

In general, where a taxpayer has entered into a binding contract or agreement to defer income before it is earned, the amounts deferred are not includible in income by a cash basis taxpayer until it is received. See Veit v. Commissioner, 8 T.C.M. 919 (1949); Oates v. Commissioner, 18 T.C. 570 (1952), aff'd 207 F.2d 711 (7th Cir. 1953).

Under the Plan, an employee makes an election to receive payment for vacation in the year before the vacation is earned. This mere right to make the election does not

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trigger the constructive receipt of income for eligible employees.

Based on the information provided and the representations made, we conclude that:

1. Under the constructive receipt doctrine of section 451 of the Code, the mere right of an employee to make an election under the Plan shall not result in taxable income for the employee under the cash receipts and disbursements method of accounting if the employee chooses not to make such an election.

2. Under the constructive receipt doctrine of section 451 of the Code, an election under the Plan made by an employee to cash out part or all of the employee's vacation leave that will be earned in a future year shall not result in taxable income for the employee under the cash receipts and disbursements method of accounting until the taxable year in which the amounts are actually paid or otherwise made available.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,
Charles T. Deliee
Chief, Executive Compensation Branch
Office of the Associate Chief Counsel
(Tax Exempt and Government Entities)