subject: Accumulated sick and vacation leave plans.

Thank you for submitting your office’s draft SCAN regarding the tax treatment under section 457(e)(11) of lump sum payments representing accumulated unused sick and vacation leave. We have attached the modified SCAN which we have revised for technical accuracy and clarity.
Does section 457(e)(11) exempt from income taxation payments for accumulated sick leave and vacation leave?

FACTS

Taxpayer is a newly retired state governmental employee who recently received payments for his accumulated sick and vacation leave. Taxpayer hears a rumor which is apparently circulating in [insert place], but which could also be circulating elsewhere. The rumor advises recipients of such payments to pay no income tax on payments for accumulated sick leave and vacation leave. The rumor’s advice states that section 457(e)(11) causes payments for accumulated sick leave and vacation leave paid by a state or local government employer to be non-taxable.

The logic underlying the rumor’s advice seems to be derived from the following IRS statement published in Notice 88-68, 1988-1 C.B. 556: “the Service has determined that regulations under section 457 will provide that bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans are not deferred compensation plans subject to section 457.” Based on this statement, the rumor wrongly concludes that if such payments are not taxable under section 457 they are never taxable income under any provision of the Internal Revenue Code.

LAW

Section 451(a) sets forth the general rule that any item of income is includible in the taxpayer's gross income in the taxable year in which paid or made available to the taxpayer.

Section 457(b) states that section 457 plans are offered by an “eligible employer,” defined in Section 457(e)(1) as a State, political subdivision of a State, any agency or instrumentality of a State or political subdivision of a State, and any organization (other than a governmental unit) exempt from tax under subtitle A.¹

Section 457(a) states that compensation from an eligible section 457 plan is deferred and becomes includible in income in the year in which the compensation is paid or becomes available to the participant.

Section 457(e)(11) states in pertinent part as follows:

(A) IN GENERAL. – The following plans shall be treated as not providing for the deferral of compensation:

(1) Any bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan.

¹ Many 457 plans are sponsored by colleges and universities.
ANALYSIS

Section 457(e)(11) deals with the proper timing for inclusion of sick leave and vacation leave compensation from an eligible employer. Section 457(e)(11) does state that sick leave and vacation leave compensation paid by an eligible employer are not deferred compensation. Since such amounts are not taxable under section 457, the tax timing question reverts to section 451(a) for the general rule that income is includible when paid or made available.

Contrary to the rumor's advice, there is no provision which excludes from income tax amounts excluded from the section 457 timing rules by section 457(e)(11). Section 457(a)(1) refers only to properly deferred compensation, and section 457 is not an exclusion provision which would designate any item as non-taxable income. Section 457(e)(11) provides that sick leave and vacation leave plans are not treated as providing for tax deferral; accordingly, section 457(a) simply does not apply to bona-fide sick leave and vacation leave plans.

As a result, the taxability issue reverts to the general rule of section 451, and amounts representing payments for unused sick leave and vacation leave are taxable during the taxable year when paid or made available to the taxpayer.

CONCLUSION:

Compensation from sick leave and vacation leave plans is includible in the gross income of the taxpayer in the year in which paid or made available to the taxpayer or the taxpayer's beneficiary. Section 457(e)(11) does not enable the taxpayer to avoid tax on the receipt of amounts representing accumulated unused sick leave or vacation leave.

REMARKS

The rumor advises taxpayers to file Form 1040X to claim a refund of income tax paid on lump sum sick leave and vacation leave compensation received from a government employer. If any 1040X is reviewed claiming a refund or credit based on section 457(e)(11), that return might be flagged for examination based on the above discussion, since section 457(e)(11) does not render the items non-taxable. Section 457(e)(11) deals only with timing for the inclusion of amounts in income and does not cause the amounts to be non-taxable income.

For further information, please contact [redacted] or [redacted] of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at [redacted].