

**Internal Revenue Service**

Department of the Treasury

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CC:IT&A:5 PLR-111682-00  
Date:  
February 14, 2001

Employer =  
E.I.N. =  
Group A =  
Group B =  
State X =

Dear

This is in reply to a letter dated May 31, 2000, submitted on behalf of the Employer. The Employer has requested a ruling on the federal income tax consequences under sections 401(k) and 451 of the Internal Revenue Code with respect to the proposed transaction.

**REQUESTED RULINGS**

1. The Group A employees' election between the Employer Benefits Program, and the Alternative Benefits Program with an additional eight percent in compensation, is not considered a "cash or deferred election" within the meaning of § 401(k).
2. An election by an employee in Group A to remain in the Employer Benefits Program, in lieu of receiving the Alternative Benefits Program with an additional eight percent in compensation, will not result in taxable income to the employee under §§ 61 or 451.

**CONCLUSIONS**

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

1. The Group A employees' election between the Employer Benefits Program, and the Alternative Benefits Program with an additional eight percent in compensation, is not considered a "cash or deferred election" within the meaning of § 401(k).

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2. An election by an employee in Group A to remain in the Employer Benefits Program, in lieu of receiving the Alternative Benefits Program with an additional eight percent in compensation, will not result in taxable income to the employee under §§ 61 or 451.

## FACTS

The Employer is represented to be an instrumentality of State X and is also exempt from federal income tax under § 501(c)(3) of the Internal Revenue Code. The employer provides educational services to the general public and also provides medical services to the general public through several hospitals operated by Group A. The Employer also maintains a group of clinics, called Group B, separate from Group A. Group A and Group B are separate operating units of the Employer and have no independent legal existence.

Currently, employees of Group A receive a package of benefits (the Employer Benefits Program) from the Employer including health insurance, dental insurance, life insurance, long-term disability benefits and participation in either the Retirement System (a defined benefit pension plan) or the Defined Contribution plan (a qualified money purchase plan providing fully vested contributions for participants). In addition, participants in the Retirement System also receive a fully vested contribution to a grandfathered State-sponsored 401(k) plan. The Employer Benefits Program is available to those Group A employees who are regularly scheduled to work twenty hours or more per week.

Employees of Group B participate in the Alternative Benefits Program and generally receive a lower level of welfare benefits. For example, participants in the Alternative Benefits Program must pay a different, generally higher, employee contribution for medical coverage, are provided less generous life insurance benefits, and must work thirty or more hours a week to be eligible for benefits. In addition, under the Alternative Benefits Program, employees of Group B receive a much lower employer contribution to the Defined Contribution Plan, and this employer contribution does not vest until completion of five years of service. No other qualified retirement benefit plan benefits are provided and participants in the Alternative Benefits Program are ineligible to participate in the Retirement System.

The Employer states that many employees of Group A have recently left employment with the Employer to take positions that offer higher cash compensation and less attractive welfare and retirement benefits. To maintain a stable work force and compete with other potential employers, the Employer proposes to permit all current Group A employees to make a one-time irrevocable election to switch from the Employer Benefits Program to the Alternative Benefits Program. A Group A employee who elects to switch from the Employer Benefits Program to the Alternative Benefits Program will receive an eight percent increase in compensation. A Group A employee

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who elects not to switch programs will continue to receive the same pay and the same benefits that he or she had immediately prior to the election.

## LAW & ANALYSIS

Section 1.401(k)-1(a)(3) of the Income Tax Regulations states that a cash or deferred election is any election (or modification of an earlier election) by an employee to have the employer either provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available, or contribute an amount to a trust, or provide an accrual or benefit, under a plan deferring the receipt of compensation.

Section 451(a) provides that the amount of any item of gross income is included in gross income for the taxable year in which the taxpayer receives it, unless, under the method of accounting used in computing taxable income, the amount is properly accounted for in a different period. Under the cash receipts and disbursements method of accounting, amounts are included in gross income when they are actually or constructively received.

For purposes of § 451(a), 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 could have drawn upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Rev. Rul. 80-300, 1980-2 C.B. 165, applied the above principle and held that an employee is not in constructive receipt of the income from stock appreciation rights (SARs) before the employee exercises those rights. Under the facts of the revenue ruling, exercise of the SARs would have resulted in the loss of the right to benefit from future appreciation in the employer’s stock without risking any capital. The revenue ruling held that forfeiture of that valuable right constituted a substantial limitation on the right to receive the income from the SARs, which precluded constructive receipt of that income.

### I. Cash or Deferred Election

In this case, a Group A employee's only options are an irrevocable election (1) to remain in the Employer Benefits Program, or (2) switch to the Alternative Benefits Program and receive an eight percent increase in compensation. The employees who choose to remain in the Employer Benefits Program will not receive any additional benefit accruals under the retirement system or participate in any other retirement program other than the one offered to them. The eight percent increase in compensation for those who choose to switch to the Alternative Benefits Program will not be converted to an actuarially equivalent benefit accrual for those who remain under the Employer Benefits Program. The employees who choose option (1) will simply continue to receive the same compensation and benefits that they received immediately

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prior to the election.

II. Income

A Group A employee who elects to receive the Alternative Benefits Program and the increase in compensation must surrender his or her right to participate in a more generous retirement plan, and will receive fewer welfare benefits under the Alternative Benefits Program than under the Employer Benefits Program. The loss of these rights under the Employer Benefits Program constitutes a substantial limitation on the right to receive the increase in compensation.

In accordance with the provisions of a power of attorney currently on file, we are sending a copy of this letter ruling to your authorized representative.

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.

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