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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Contact:
Index (UIL) Number: 457.00-00; 3121.16-00; 3401.01-00
CASE MIS Number: TAM-108593-98

District Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Year Involved:
Date of Conference:

LEGEND:

Taxpayer:
Employer:
Year :
Contract:

State X:

ISSUE(S):

1. Whether Employer's Contract provides for severance pay or deferred compensation?

2. If Contract provides for deferred compensation, whether the amount payable to a teacher at retirement is subject to a substantial risk of forfeiture as defined in Internal Revenue Code section 457(f), where the teacher has satisfied the "rule of 73" eligibility requirement under Contract, but can be terminated "for cause", thus forfeiting the payments due at retirement?

3. If Contract provides for deferred compensation, whether the amount payable under Contract is includible in gross income in the year a teacher satisfies the "rule of 73" regardless of whether a teacher actually retires at that time and regardless of whether the amount is not paid or made available until a teacher actually retires?

4. Whether the benefits are subject to Federal Insurance Contribution Act ("FICA") tax under section 3121(v)(2) in the year that the "rule of 73" is satisfied?

5 Whether the benefits are subject to federal income tax withholding under sections 3401 and 3402 at the time that the "rule of 73" is satisfied?

CONCLUSION:

1. Contract provides for deferred compensation and is subject to section 457 of the Code. Contract is not an eligible plan under section 457(b), and is therefore an ineligible plan subject to the requirements of section 457(f) of the Code. Under section 457(f) of the Code, compensation deferred is includible in gross income in the first year that a participant's right to the compensation is not subject to a substantial risk of forfeiture as defined in section 457(f).

2. The amount payable to a teacher at retirement under Contract is not subject to a substantial risk of forfeiture as defined in section 457(f), once the teacher has satisfied the "rule of 73" eligibility requirement under Contract, even though the teacher can be terminated "for cause", thus forfeiting the payments due at retirement.

3. The amount payable to a teacher is includible in his or her gross income in the year a teacher satisfies the "rule of 73" and the amounts are no longer subject to a substantial risk of forfeiture, regardless of whether the teacher retires at that time and regardless of whether the amount is paid or made available at that time.

4. Benefits under Contract are not required to be taken into account for FICA tax purposes under section 3121(v)(2) in the year that the "rule of 73" is satisfied.

5. Benefits under the Contract are not subject to income tax withholding at the time they are included in income under section 457(f).

FACTS:

Employer is a school district in State X. Employer is a separate political subdivision under the laws of State X. Employer, as a political subdivision of State X, has only those powers and authority granted by statute, or necessarily implied therefrom. Employer has for many years had the authority to offer "severance payments" as described and defined within State X's statute. This memorandum refers to the payments as "severance" only to reflect the language used in Employer's contracts, and

not to state any conclusion as to the character of the payments. In addition, the terms "agreement" and "contract" are often used interchangeably.

Employer initially negotiated a severance provision with its teachers for the 1974-1975 period. Under these first agreements, Employer would pay severance (equal to an amount representing 25 days' pay plus an amount equal to 25% of an eligible teacher's unused sick leave days, not to exceed 25 days' pay) to a teacher upon retirement from the school district provided the teacher had completed 20 years of service, and had attained at least 55 years of age. Both components of the severance pay were subject to a proration formula which decreased the benefit by 20 % for each year that the teacher exceeded age 60 at the end of the school year in which retirement occurred. In addition, no benefit was payable if the teacher was age 65, or older, at the end of the school year in which retirement occurred. Benefits were to be paid in equal annual installments over a period of time not to exceed five years from the effective date of retirement. The benefit was not granted to any teacher who was discharged "for cause" by Employer, as defined under State X's "continuing contract law." No teachers have ever been terminated or discharged for cause in Employer's school district, although teachers have been discharged "for cause" in other school districts in State X.

The severance benefit was increased in the 1975-1977 agreement, so that a teacher could receive a benefit representing 50 days' pay and 50% of unused sick leave, not exceeding an amount representing 50 days' pay. All other provisions remained the same. Starting in 1977, State X also authorized Employer and other school districts in State X, by state statute, the opportunity to provide its teachers with an "early retirement incentive," of up to $7500, payable to any eligible teacher between the ages of 55 and 65 (with at least 15 years of teaching service) who actually terminates service with a school district in State X. The $7500 amount is reduced by $375 for each year that a teacher is over the age of 55 to a maximum age of 60, and by an additional $1,125 for each year that a teacher is over age 60.

In the 1981-1983 agreement, the eligibility requirement for the severance benefit was changed from 20 years of service to 18 years of service. In addition, an eligible teacher could now receive 60% of unused sick leave, not to exceed an amount representing 65 days' pay. Finally, a death benefit was added whereby if a retired teacher died before all or a portion of the severance pay was disbursed, the balance would be paid to a named beneficiary or the decedent's estate.

The 1987-1989 contract increased the period of time that a teacher was eligible to receive full severance benefit, so that the prorated 20% reduction of benefits began at age 62. The effect of this change was that a teacher was still eligible to receive 20%, rather than 0%, of severance pay at age 65. The 1989-1991 contract made a few more minor adjustments. The sick leave component dropped the cap of 65 days, and an eligible teacher could receive 60% of his or her total number of unused sick leave (out

of a possible 120 day sick leave accumulation.). Consequently, an amount representing up to 72 days of sick leave pay could be provided by Employer. Additionally, the contract now provided for payment to be made over a period not exceeding (5) years from the effective date of retirement, instead of requiring equal annual installments over that same time period.

The 1991-1993 Contract substantially modified the severance benefit. The title of the relevant Article in the contract was changed from "Early Retirement" to "Severance Pay and Deferred Compensation." The Contract provided, for the first time, an employee election to make salary reduction contributions to State X's Deferred Compensation Plan, an eligible section 457(b) plan. In addition, Employer has represented that during the negotiations of the 1991-1993 collective bargaining agreement, "the teacher's exclusive representative requested that the severance pay provision be phased out over a period of time, and be replaced with a deferred compensation plan." In response to that request, commencing July 1, 1991, full time teachers beginning their fourth year (or more) of actual service to the Employer became entitled to make elective contributions to State X's Deferred Compensation Plan which would be matched 100% by the Employer, up to $500 per school year.

In addition, and most relevant to this memorandum, the 1991-1993 Contract provided that full time teachers hired prior to July 1, 1988, who attained age 55 and 18 years service would be entitled to a severance payment upon retirement from Employer. So as not to penalize teachers who were eligible for severance pay under previous contracts and who remained employed with Employer, Employer entered into an agreement to provide each teacher hired before July 1, 1988, a benefit of an amount not exceeding $26,000 to teachers at least age 55 with 18 years of service. This severance benefit is a combination of "the amount of the matching funds Employer paid to a teacher under the new deferred compensation plan, plus 4% interest accumulated thereon, plus whatever dollar amount is required to reach a $26,000 guarantee." Any amount due to the teacher from Employer upon reaching the age and service requirements is paid at the time of retirement in one lump sum or annual payments over a period not to exceed five years, at the option of Employer. A teacher discharged "for cause" by Employer is not eligible for a payment from Employer under this provision of Contract, and forfeits the amounts.

This Contract also removed the age proration calculation for the benefit payments. This was done as a response to a finding by State X's Department of Human Rights that "a severance pay plan that failed to pay a severance benefit to an employee who completed the service requirement but had not attained age 45 was an unfair discriminatory practice" in violation of State X law. In addition, Contract removed the prorated reduction of benefits for older employees as well.

This new provision completely replaced the provisions of the previous contracts dealing with severance benefits for teachers of Employer. Thus, this Contract removed the age proration calculation for severance benefit payments. Contract does not require the performance of substantial services by any individual after reaching the "rule of 73" in order to receive these benefits, and the teachers no longer risk a reduction of benefits by staying with Employer beyond a certain age. Teachers are paid these amounts upon retirement from employment with Employer (to the extent needed to total an amount equaling $26,000 after taking into consideration the amount of the Employer matches over the years.) Teachers hired after July 1, 1988 are not entitled to benefits under this provision of the contract.

Under the 1993-1995 contract, the former eligibility requirement of age 55 and 18 service was restated as the age and service totaling 73 ("rule of 73") requirement. Beginning on July 1, 1994, a teacher could direct that his or her elective deferrals and the Employer's match (up to $500) be deposited in a section 403(b) tax-sheltered annuity or State X's Deferred Compensation Plan under section 457(b) plan. Other changes were also made in this Contract. Part-time teachers hired prior to July 1, 1988 were allowed to participate in the severance plan on a non pro-rated basis if their total service was equal to or greater than 18 years equivalent of full-time service. In addition, the death benefit was improved to provide severance benefits to a teacher who met the "rule of 73" but died before all benefits under the contract have been received.

The 1995-1997 Contract remained unchanged with respect to the severance and deferred compensation benefits.

Based on employer's 1995 payroll records, 114 active teachers hired before July 1, 1988 will be entitled to severance pay upon satisfying the age and service "rule of 73" requirements. Of those, approximately 87% participate in the Employer's matching program for section 403(b) and section 457(b) plans. Each employee, on average, satisfied the "rule of 73" seven years prior to actual retirement. In 1995 and 1996, six teachers of more than 46 who satisfied the "rule of 73" retired and received benefit payments from Employer, paid out in approximately equal installments over a two year period. Federal income taxes and FICA taxes were withheld as the payments were made to the retiring employees. Payments were made from Employer's funds for employee compensation, and reported on a Form W-2 issued under Employer's regular payroll procedures.

LAW AND ANALYSIS:

A deferred compensation plan is an agreement or arrangement between an employer and employees under which the payment of compensation is deferred. The tax

consequences of such plans are governed by the constructive receipt doctrine embodied in the regulations under section 451 of the Code, and, in the case of public and tax exempt employers, section 457 of the Code, unless the agreement or arrangement falls within one of the exceptions to the requirements of section 457.

The constructive receipt of income doctrine has long been a part of the income tax laws. Under this doctrine, a taxpayer will be subject to tax upon an item of income if he has an unrestricted right to determine when such an item of income should be paid. This principle was expressed in a 1930 Supreme Court case, Corliss v. Bowers, 281 U.S. 376 (1930), in a statement by Mr. Justice Holmes, that "Income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."

This doctrine is embodied in section 1.451-1(a) of the Income Tax Regulations, which states that an item of income (for example compensation for services) is includible in gross income for the taxable year in which it is actually or constructively received. Section 1.451-2(a) of the regulations states that income is constructively received in the year in which, although not actually received, it is made available so that the taxpayer could actually draw upon it at any time if notice of intention to withdraw it has been given. However, income is not constructively received if the taxpayer's control over its receipt is subject to substantial limitations or restrictions.

Section 457 of the Code provides for the income tax treatment of compensation for services deferred by an individual under an eligible deferred compensation plan of a state or local government entity or a tax-exempt organization. Section 457 provides special rules whereby an individual who participates in such a plan will not be deemed to be in constructive receipt of a portion of his compensation for services rendered to an eligible employer. For this purpose, a plan is treated as an eligible plan if the plan provisions conform to the requirements of § 457 of the Code and the plan is administered in conformance with the eligibility requirements of section 457(b).

In Notice 87-13, 1987-1 C.B. 432, Q-and A-26, the question of which types of plans are subject to section 457 was addressed:

> Section 457 applies to amounts deferred under a deferred compensation plan regardless of whether the plan is in the nature of an individual account or defined contribution plan or defined benefit plan, including a deferred compensation plan that provides benefits in excess of the benefits provided under a qualified plan under section 401(a), a deferred compensation plan that provides benefits in excess of the benefits permitted to be provided under a qualified plan on account of section 415, and a deferred compensation plan that provides benefits only to a select group of executives or other highly compensated employees (e.g. a "top

hat" plan). Also, section 457 applies to amounts deferred even though deferred amounts are determined by reference to factors other than the annual compensation of the individual (e.g., years of service, final average salary), are uncertain in aggregate amount, and are payable over an indeterminable period (e.g., over the life of the individual).

Section 457(a) provides that compensation deferred under an eligible plan and any income attributable to such deferred compensation are taxable only for the year in which the deferred amounts are "paid or made available" to the plan participant or the participant's beneficiary, not in the year in which the amounts are deferred.

Section 457(f)(1)(A) provides that in the case of a plan of an eligible employer providing for a deferral of compensation, if such plan is not an eligible deferred compensation plan, then the compensation is included in the gross income of the participant or beneficiary in the first taxable year in which there is no substantial risk of forfeiture to the rights of such compensation.

Section 457(f)(2)(A) provides that the term "plan" includes any agreement or arrangement.

Section 457(f)(3)(B) provides that the rights of a person to compensation are subject to substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

Section 83 of the Code and the regulations thereunder provide additional assistance in determining what is a substantial risk of forfeiture and what kinds of services are substantial for purposes of section 457(f).

Section 1.83-3(c)(1) of the regulations provides that whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Section 1.83-3(c)(2) of the regulations point out that requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture. But, if the amounts are forfeited because an employee leaves before rendering two years of service with the employer, a substantial risk of forfeiture will be considered to exist.

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Section 457(e)(1) provides that the term "eligible employer" means, among other things, a State, a political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State.

Section 457(e)(6) provides that compensation shall be taken into account at its present value.

Section 457(e)(11) provides that any bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan shall be treated as a plan not providing for the deferral of compensation.

There is currently no interpretative guidance issued by the Internal Revenue Service, either in the form of regulations or otherwise, defining "bona fide severance pay plan" for purposes of section 457(e)(11). However, other sections of the Code, the Department of Labor regulations, and the case law do provide some assistance. It should be noted, however, that these other Code sections, regulations and cases determine whether an arrangement is one of deferred compensation and not whether the plan may be characterized as "a bona fide severance pay plan" under section 457(e)(11).

"Severance pay" generally connotes payment to an employee because of his or her termination of employment under an unanticipated set of circumstances, rather than compensation that has been unconditionally deferred until termination of employment. Severance plans have as their basic function the payment of benefits on account of a separation from service due to a contingency beyond the control of the employee. For example, employees who are laid off or dismissed by an employer due to corporate downsizing or restructuring would be paid these benefits, while those that held their jobs would have no rights to the funds. Thus, these arrangements generally provide payments to employees because employment has been terminated, not simply when employment terminates. Payments regarded as severance may also include payments made to employees who voluntarily terminate employment, most often before attainment of retirement age, as part of a window-type early retirement incentive program.

In contrast, the more common nonqualified deferred compensation arrangement would be structured to postpone the receipt of compensation in order to delay the payment of income taxes until the payment of benefits under the plan, usually when the participant retires, separates from service, dies or becomes disabled.

Section 3(2)(B) of the Employee Retirement Income Security Act of 1974 ("ERISA") authorizes the Secretary of Labor to adopt regulations under which severance pay arrangements will be classified as welfare benefit plans rather than pension plans for purposes of Title I of ERISA. This section further provides that a plan shall

nevertheless be treated as a pension plan if it has the principal effect of evading the standards applicable to pension plans.

Under section 3(2)(A), a "pension plan" is generally defined as a plan that provides retirement income to employees or results in a deferral of income by employees for periods extending to the time of termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits under the plan.

Section 3(1) of ERISA defines an "employee welfare benefit plan" generally as a plan maintained for the purpose of providing medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, as well as some other specific benefits.

Section 2510.3-2(b)(1) of the Labor regulations under ERISA provides that an arrangement providing for "severance benefits on account of" termination of employment will not be treated as a pension plan if (i) the payments are not contingent, directly or indirectly, on the employee's retirement, (ii) the total payments do not exceed twice annual compensation, and (iii) the payments are generally completed within two years of termination of employment. Apart from the three specific requirements, the regulation is limited to plans that pay "severance benefits on account of termination of employment...."

One case that addressed this issue concluded that all of these conditions must be satisfied for an arrangement to qualify as "severance pay," and that this regulation has no applicability to a plan that unconditionally provides benefits upon termination of employment. See, Lima Surgical Associates, Inc, v. United States, 944 F.2d 885 (Fed. Cir. 1991) aff'g 20 Cl. Ct. 674, 686-687 (1990).

While state and local governments and tax-exempt employers take no deductions for contributions made to their plans, the sections of the Internal Revenue Code dealing with deductions for taxable employers provide further insight into the different treatment of severance plans and deferred compensation plans. If a plan is a plan of deferred compensation, then section 404 will govern the timing of the deduction for income tax purposes. If the plan is something other than a deferred compensation plan, such as a severance pay plan or other welfare benefit plan, then section 419 governs when an employer may take a deduction for contributions made to the plan.

Section 404 sets out the rules governing the timing of employer deductions under nonqualified deferred compensation arrangements and qualified plans of taxable employers. If a plan is a deferred compensation plan, then payments are deductible under section 404(a)(5) of the Code only "in the taxable year in which an amount

attributable to the contribution is includible in the gross income of employees participating in the plan." Section 1.404(a)-12(b)(2) of the Income Tax Regulations elaborates that "if unfunded pensions are paid directly to former employees, such payments are includible in their gross income when paid, and accordingly, such amounts are deductible under section 404(a)(5) when paid."

The regulations under section 404 distinguish between welfare benefit plans and deferred compensation plans. Section 1.404(a)-1(a)(2) of the income tax regulations provides that section 404 does not apply to contributions to a plan that is "solely a dismissal wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare or similar benefit plan, or a combination thereof." This same regulation provides that "if under a plan an employer contributes 5 percent of each employee's compensation per month to a fund out of which employees who are laid off will be paid benefits for temporary periods, but employees who are not laid off have no rights to the funds, such a plan is an unemployment benefit plan...." Section 1.404(a)-1(a)(3) of the regulations further provides that when a plan has the features of both kinds of plans, the entire plan is evaluated under section 404(a). .

Section 419(a), as enacted by the Tax Reform Act of 1984, prescribes limitations on deductions for contributions paid or accrued with respect to welfare benefit plans after December 31, 1985, in taxable years of employers ending after that date.

Prior to the enactment of section 419, section 162 governed the timing of deductions for contributions to welfare benefit plans and such deductions were allowed for all the "...ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...." Under section 1.162-10(a) of the Income Tax Regulations, amounts may nevertheless not be deductible under section 162(a) "if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in section 404(a)."

The case law in this area, which generally deals with pre-1986 deduction issues under section 162, has determined that so-called severance pay plans providing for payments in all events following termination of employment are deferred compensation plans, rather than dismissal or unemployment benefit plans. See New York Seven-Up Bottling Co. v. Commissioner, 50 T.C. 391 (1968); New York Post Corp. v. Commissioner, 40 T.C. 882 (1963).

The Seventh Circuit Court of Appeals in Wellons v. Commissioner, 31 F.3d 569, (7th Cir. 1994), aff'g T.C. Memo. 1992-704, reviewed the issue of whether an employer's plan constituted a severance pay plan or a plan of deferred compensation for purposes of the employer's deduction under Section 404(a)(5) of the Code. Under that plan, a participant who terminated employment was entitled to a benefit equaling twenty-one

(21) weeks of average weekly compensation for each year of service. The maximum allowable benefit was two times the annual salary of the participant for the year immediately preceding termination, and the benefits were paid under the plan within twenty-four (24) months of the severance. The Seventh Circuit Court, in affirming the Tax Court on this issue, determined that the plan in question was a plan of deferred compensation, even though it had some of the characteristics of a welfare benefit plan. The Court noted that:

> On its face, Wellons' plan seems more akin to a pension plan than to a plan providing benefits corresponding to those listed alongside "welfare" benefits in 26 C.F.R. section 1.404(a)-1(a)(2). The instant plan is most akin to an arrangement providing either dismissal wages or unemployment benefits, but even these categories are obviously intended to apply narrowly in limited circumstances, and these plans operate more as insurance in case of a contingent event than as a guarantee of income upon a certain event. Wellons plan, by contrast, covers all employees who leave his employment for whatever reason. Similar to a pension plan, the benefits vest after five years of employment and are commensurate with salary and length of service.

Wellons, supra, at 571-572.

Based on this analysis, the Court determined that the contributions to the plan were governed by section 404(a)(5) and deductible only in the years when benefits were actually paid, disallowing the deductions taken pursuant to section 162. The Court determined this despite the fact that the plan was set up to comply with the ERISA regulation dealing with severance pay plans under section 2510.3-2(b)(1) of the Labor regulations.

A third analogous area where a distinction is made between severance pay plans and deferred compensation plans is under section 501(c)(9) of the Code, which defines tax exempt voluntary employee beneficiary associations ("VEBAs").

Section 501(c)(9) defines a "VEBA" as a tax-exempt entity created to fund life, sick, accident or other benefits for members, their dependents or designated beneficiaries. Section 1.501(c)(9)-3(d),(e) and (f) of the regulations states that a VEBA may provide a benefit that "protects against a contingency that interrupts or impairs a member's earning power," including severance benefits described in the Department of Labor regulation, but not a benefit that is "...similar to a pension or annuity payable at the time of mandatory or voluntary retirement...." Section 1.501(c)(9)-3(f) of the income tax regulations also states that "...a benefit will be considered similar to that provided under a pension, annuity, stock bonus or profit sharing plan if it provides for deferred

compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event."

Section 6064(d)(2) and (3) of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") provides two grandfather rules which exclude some deferred compensation arrangements maintained by governmental plans from the requirements of section 457. Section 6064(d)(2)(A) states that section 457does not apply to "nonelective deferred compensation provided under a plan in existence on December 31, 1987, and maintained pursuant to a collective bargaining agreement." Section 6064(d)(2)(B) defines a "nonelective plan" as a plan which covers a broad group of employees and under which the covered employees earn nonelective deferred compensation under a definitive, fixed and uniform benefit formula." Section 6064(d)(2)(C) of TAMRA provides that a plan's grandfather status ends, and section 457 will apply, as of the first effective date of the first material modification of the plan agreed to after December 31, 1987.

Notice 88-98, 1988-2 C.B. 421, states that a modification is not material unless it modifies the plan's benefit formula or expands the class of participants beyond those participants under the plan on or before December 31, 1987.

Section 6064(d)(3) of TAMRA states that section 457 does not apply to amounts deferred under a nonelective deferred compensation plan maintained by an eligible employer if (either) such amounts were deferred from periods before July 14, 1988, (or) such amounts were deferred from periods on or after July 14, 1988, pursuant to an agreement which was in writing on July 14, 1988, which provided for deferral of a fixed amount at that date, and the individual for whom the deferral is made is covered under such agreement on such date. Section 6064(d)(3)(B) of TAMRA provides that a plan's grandfather status ends, and section 457 will apply, in any taxable year ending after the date on which such modification to the plan changes the fixed amount or formula in effect before January 1, 1989.

Notice 87-13, 1987-1 C.B. 432, in Q-and-A 28 provides that an amount of deferral that is pursuant to a written plan on August 16, 1986, will cease to be treated as fixed on such date, and thus will be subject to section 457, as of the effective date of any modification to the written plan that directly or indirectly alters the fixed dollar amount, the fixed percentage, the fixed base amount to which the percentage is applied, or the fixed formula.

Under sections 3101 and 3111, taxes under the FICA are computed as a percentage of "wages" paid by the employer and received by the employee with respect to "employment." In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term "wages" or the services are specifically excepted

from the term "employment." Section 31.3121(a)-1(h)(i), Employment Tax Regs. Section 31.3121(a)-2(a) provides that, in general, wages are paid by an employer at the time that they are actually or constructively paid.

Section 3121(a)(5)(E) exempts from "wages" any payment made to, or on behalf of, an employee or his beneficiary under or to an "exempt governmental deferred compensation plan" (as defined in subsection (v)(3)). Section 3121(v)(3) states that, for purposes of subsection (a)(5), the term "exempt governmental deferred compensation plan" shall not include a plan to which section 457(a) or (f)(1) applies.

Section 3121(v)(2) provides that any amount deferred under a nonqualified deferred compensation plan shall be taken into account for FICA purposes as of the later of when the services are performed, or when there is no substantial risk of forfeiture of the rights to such amount. Section 3121(v)(2)(C) provides that the term "nonqualified deferred compensation plan" means any plan or other arrangement for the deferral of compensation other than a plan described in section 3121(a)(5). The arrangement in this case is not described in section 3121(a)(5).

Section 31.3121(v)(2)-1(b) of the Proposed Regulations defines deferral of compensation:

> (i) Deferral of compensation defined. A plan provides for the "deferral of compensation" with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable in a later year. An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer. . . . Similarly, an employee does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under section 401(a) of the Internal Revenue Code.

The proposed regulation goes on to describe benefits which do not result in the deferral of compensation. Section 31.3121(v)(2)-1(b)(4)(iv) provides:

> Vacation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits do not result from the deferral of compensation for purposes of section 3121(v)(2), even if those benefits constitute wages within the meaning of section 3121(a). Benefits provided under a severance pay plan that is not an employee pension

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benefit plan pursuant to 29 CFR 2510.3-2(b) are considered "severance pay" for purposes of this paragraph (b)(4)(iv). If a plan is an employee pension benefit plan pursuant to 29 CFR 2510.3-2(b), then whether benefits payable upon an employee's termination of employment are considered severance pay for purposes of this paragraph (b)(4)(iv) depends upon the relevant facts and circumstances. Notwithstanding the preceding sentence, a plan that is an employee pension benefit plan pursuant to 29 CFR 2510.3-2(b) is in all cases considered to provide severance pay for purposes of this paragraph (b)(4)(iv) if benefits payable under the plan upon an employee's termination of employment are payable only if that termination is involuntary.

The proposed regulations under section 3121(v) provide examples of what is meant by "deferred compensation" within the meaning of section 3121(v).

Example 2. (i) Employer N establishes a compensation arrangement for Employee B in 1997. Before the beginning of 1998, Employee B and Employer N enter into a legally binding salary reduction agreement to defer a specified percentage of Employee B's salary that would otherwise be payable in 1998. The amounts deferred remain a general asset of Employer N, and are payable in 2008.

(ii) Employee B has a legally binding right during 1998 to an amount of compensation that has not been actually or constructively received and that, pursuant to the terms of the arrangement, is payable in a later year. Therefore, the arrangement provides for the deferral of compensation.

On the other hand, Example (9) illustrates the concept of "severance pay," which is not subject to section 3121(v)(2):

Example 9. (i) Employer U establishes a plan which provides for payments solely upon an employee's dismissal from employment, death, or disability. The amount of the payments to an employee is based on the length of continuous active service with Employer U at the time of dismissal, and is paid in monthly installments over a period of three years.

(ii) Because benefits payable under the plan upon termination of employment are payable only upon an employee's involuntary termination, the plan is a severance pay plan within the meaning of paragraph (b)(4)(iv) of this section. Thus, the benefits are not treated as resulting from the deferral of compensation for purposes of section 3121(v)(2).

The proposed regulations under section 3121(v)(2) contain specific provisions dealing with the time when amounts deferred are taken into account for FICA purposes. Section 31.3121(v)(2)-1(e). Under a nonaccount balance plan, as in this case, the amount is not required to be taken into account until the "resolution date," i.e., the date when the amount is reasonably ascertainable.

> For purposes of this paragraph (e)(4), an amount deferred is considered reasonably ascertainable on the first date on which the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest, mortality, and cost-of-living assumptions. If these assumptions are the only assumptions regarding future events or circumstances that are needed to determine the amount deferred as of a particular date, then the amount deferred will not fail to be reasonably ascertainable merely because the exact amount deferred cannot be readily calculated as of that date.[1] Section 31.3121(v)(2)-1(e)(4)(i).

Section 31.3121(v)(2)-1(e)(7) provides the following relevant examples:

> Example 4. (i) In 1997, Employer N establishes a nonqualified deferred compensation plan under which all benefits are 100 percent vested. The plan provides for Employee B (who is age 45) to receive a lump sum benefit of $500,000 at age 65. This benefit will be forfeited if employee B dies before age 65.
>
> (ii) Because the only assumptions needed to determine the amount deferred are interest and mortality, the amount deferred is reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section.
>
> Example 5. (i) The facts are the same as in Example 4, except that the $500,000 is payable to Employee B at the later of age 55 or termination of employment.
>
> (ii) Because the present value of the future benefit is contingent on when Employee B terminates employment, the determination of the amount deferred requires the use of assumptions other than interest, mortality,

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[1] An employer may elect to take an amount into account before the resolution date, provided that the services creating the right to the amount deferred are performed and the amount is not subject to substantial risk of forfeiture. If the amount taken into account is less than the resolution date amount for the same period, the balance must be taken into account as of the resolution date. Section 31.3121(v)(2)-1(e)(4)(ii).

> and cost-of-living assumptions. Thus, the amount deferred is not reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section.

The regulations provide another example (6) according to which an employee may elect to take the benefit in the form of a lump sum or a life annuity. The present value of the two options is not the same, so the amount deferred is not reasonably ascertainable.

Section 3402(a)(1) imposes upon "every employer making payment of wages" the duty of withholding federal income tax from wages of an employee. Section 3401(a) defines wages for federal income tax withholding purposes as all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, with certain enumerated exceptions. None of the exceptions in section 3401(a) applies to these benefits. Section 31.3401(a)-1(b) of the Employment Tax Regulations provides:

> The employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time and their payment brought within his own control and disposition.

The first issue to be determined is whether the benefits guaranteed to teachers hired before July 1, 1988, with respect to those who satisfy the "rule of 73," under the relevant contract, are severance benefits "exempted" from section 457 or are deferred compensation benefits, subject to the requirements of section 457. In addition, we must also determine whether the benefits provided are grandfathered from the requirements of section 457. If we determine that Contract provides deferred compensation benefits, then we must determine whether Contract is an eligible plan under section 457(b). If Contract is not an eligible plan, then it is an ineligible plan, and we must decide whether the amount payable to a teacher at retirement is subject to a substantial risk of forfeiture as defined in section 457(f), where the teacher has satisfied the "rule of 73" eligibility requirements, but can be terminated "for cause", thus forfeiting the payments due at retirement. Finally, if the benefit amount is not subject to a substantial risk of forfeiture after a teacher satisfies the "rule of 73," we must decide whether the amounts payable to a teacher are includible in gross income in the year a teacher satisfies the "rule of 73" regardless of whether the teacher actually retires at

that time and regardless of whether the amount is not paid or made available until a teacher actually retires.

Contract described above is one of deferred compensation. Any arrangement of a political subdivision of a State that provides nonqualified deferred compensation to its employees is subject to section 457, unless an exception to coverage under section 457 exists. Under Contract at issue, beginning in the 1991-1993 contract year and including the relevant Year involved under Contract, the benefits provided are deferred until termination of employment as under a deferred compensation plan. While the benefits provided are labeled severance pay, they do not differ in any meaningful manner from a deferred compensation plan. The teachers are eligible to get their money at retirement upon satisfying the age and service requirement under the "rule of 73" no matter what their reason for terminating employment. There is very little, if any, extra benefit provided to a teacher who terminates employment at a time earlier than they otherwise might have. The benefits are simply paid when a teacher retires and not because a teacher retires. There is no contingency that is normally associated with severance pay plans. Thus, Contract is not a bona fide severance pay plan under section 457(e)(11) and is not excepted from the requirements of section 457. We conclude this even though the benefit under Contract may be limited to two times the annual compensation of the teachers and is ultimately paid out within two years time (although a 5 year payout is permitted), and even though the original contracts may have provided for something other than deferred compensation.

Employer contends that, like the pre-1991 contracts, the $26,000 total amount is reduced by a specific amount each year (this amount is equal to Employer's matching contribution to a teacher's deferred compensation plan plus four percent) and that this reduction is intended to act as an incentive for teachers to retire after reaching age 60, in the same way that the prior contract's reduction of 20 percent per year starting at age 60 (reducing down to zero at age 65) was intended to do. Thus, Employer argues that the contract provision is designed to entice teachers who have reached the high end of the teachers' salary schedule to retire early so that they can be replaced with entry-level teachers at a substantial cost savings to the Employer, and is therefore a severance pay plan.

We do not find this analysis convincing. Under the prior contract, the payment was actually eliminated if a teacher remained at work until age 65. Under the contract now at issue, a teacher is entitled to a $26,000 benefit upon reaching the "rule of 73." A teacher who does not elect to participate in either State X's deferred compensation plan under section 457(b) or State X's section 403(b) plan gets the full $26,000 under Contract at retirement. A teacher who elects to make salary reduction contributions under either State X's deferred compensation plan under section 457(b) or State X's section 403(b) plan gets up to a $500 annual match, which ultimately reduces the $26,000 guarantee by the amount of the matches. However, the amount received

under this second scenario also equals $26,000, it is just paid from different pockets of Employer. Under prior contracts, the benefit was reduced down to zero at age 65. Under Contract at issue, there is no such loss of benefit. We do not view the offering of the guaranteed benefit paid at retirement under Contract as providing any incentive for teachers to retire early. In fact, most teachers worked an average of seven years beyond the "rule of 73," some as many as fifteen. Contract provided no additional incentive for a teacher to retire early.

The next issue to be determined is whether the benefits provided under Contract are nevertheless outside of the requirements of section 457 because of the grandfather rules articulated in sections of 6064(d)(2) and 6064(d)(3) of TAMRA. Under the facts presented, substantial modifications in the agreement and Contract at issue materially modified the benefit formula in effect before January 1, 1989. Therefore, Contract is not grandfathered and is subject to the rules under section 457.

Contract is therefore subject to the requirements of section 457. That being the case, we need to determine whether Contract is an eligible plan subject to section 457(b) or an ineligible plan under section 457(f) of the Code. Contract was not created as an eligible deferred compensation plan, and does not meet the eligibility requirements set out under section 457(b) of the Code. It is therefore not an eligible plan under section 457(b).

Because this is a plan of an eligible employer providing for a deferral of compensation that is not exempted as a bona fide severance pay plan from section 457 under section 457(e)(11), is not a grandfathered plan, and is not an eligible deferred compensation plan under section 457(b), Contract is an ineligible plan under section 457(f). As such, the compensation deferred pursuant to Contract is included in the gross income of the participant or beneficiary in the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation. Under Contract, teachers are entitled to a benefit totaling approximately $26,000 upon satisfying the "rule of 73," unless a teacher is terminated "for cause" between the time he or she satisfies the "rule of 73" and the actual date of a teacher's retirement with Employer. Section 1.83-3(c)(2) of the regulations specifically states that requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture. Thus, because the teacher's rights to compensation are not conditioned upon the future performance of substantial services by any individual upon meeting the requirements of the "rule of 73," and are not subject to a substantial risk of forfeiture beyond that time, there is no substantial risk of forfeiture of the teacher's rights to the compensation beginning at that time.

Section 457(f)(1)(A) provides that in the case of a plan of an eligible employer providing for a deferral of compensation, if the plan is not an eligible deferred compensation plan, then the compensation is included in the gross income of the participant or beneficiary

in the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation. Accordingly, under section 457(f)(1), a teacher is taxed on the present value of the payments in the first taxable year the teacher is eligible to receive the benefits under the "rule of 73" (when the amounts are no longer subject to a substantial risk of forfeiture), regardless of whether the teacher actually retires at that time and regardless of whether the amount is not paid or made available until a teacher actually retires.

The next issue is the application of FICA tax to benefits under Contract. Because we have concluded that section 457(f) applies to Contract, it is not an exempt governmental deferred compensation plan under section 3121(v)(3) and benefits are not exempted from wages under section 3121(a)(5)(E).

Under the terms of Contract and the facts of this case, an employee who was hired before July 1, 1988, and who meets the "rule of 73" has a legally binding right during a calendar year to compensation that has not been actually or constructively received, that, pursuant to the terms of Contract, is payable in a later year, and that is not subject to a substantial risk of forfeiture. Therefore, if benefits under Contract do not constitute severance pay, Contract provides for the deferral of compensation under section 3121(v)(2).

On the basis of the information submitted, the benefits under Contract do not appear to constitute severance pay for purposes of section 3121(v)(2). Consequently, the rule that severance pay does not result from the deferral of compensation for purposes of section 3121(v)(2) does not apply. Rather, the application of FICA is governed by section 3121(v)(2).

Under section 3121(v)(2), an amount deferred is not required to be taken into account until the amount is reasonably ascertainable. Benefits under Contract are not reasonably ascertainable because, once an employee satisfies the "rule of 73," the payment date depends upon the year in which the employee terminates employment. Because the amount is not reasonably ascertainable at the time the "rule of 73" is satisfied, the payments in question are not required to be taken into account for FICA tax purposes at that time.

Although the benefits under the plan are wages for income tax withholding purposes, the benefits in question are not actually or constructively paid. They are subject to a substantial limitation or restriction in that the employees must leave their jobs before they can obtain the benefits. Thus, even though an amount of compensation is included in income under section 457(f), there is no special rule under section 3402 analogous to 457(f)(1), which would subject these amounts to income tax withholding at the time they are no longer subject to a substantial risk of forfeiture.

The benefits are therefore not subject to income tax withholding at the time they are included in income under section 457(f).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.