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DEPARTMENT OF
EMPLOYEE RELATIONS

CITY OF SACRAMENTO
CALIFORNIA

801 NINTH STREET
ROOM 105
SACRAMENTO, CA
95814-2693

March 10, 1988

916-449-5424

Law and Legislative Committee
City Council
Sacramento, California

Honorable Members in Session:

SUBJECT: Taxation of Accrued Leave Benefits (Support of H.R. 3312)

SUMMARY

House Resolution 3312 would reverse an interpretation by the Internal Revenue Service to tax leave benefits such as vacation, sick leave, and compensating time off (CTO) at the time of accrual rather than when used.

It is recommended that the Committee support this bill.

BACKGROUND

Under IRS regulations, local and state agencies had assumed that accrued benefits such as vacation, sick leave, and CTO were subject to taxation at the time of use. However, with the passage of the Internal Revenue Code of 1986, the IRS has issued a new interpretation which would tax these benefits at the time of accrual. (See attached IRS Notice 88-8.)

On September 21, 1987, Congressman Matsui introduced H.R.3312 which would reverse the new IRS interpretation by legislative correction. The bill has been referred to Ways and Means Committee and is scheduled for a hearing this month.

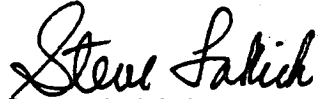
If the interpretation of IRS is not changed by legislative action, public employers will be faced with complicated payroll deduction and reporting problems. The present City system is established on a cash rather than an accrued basis and the complications related to the IRS interpretation may disrupt the integrity of our payroll system. Also, employees will be required to pay a premature tax. Initially, employees would be required to pay taxes on both the new accruals and the carried-over leave balances.

The League of California Cities and other major public interest groups are in support of H.R. 3312.

RECOMMENDATION

It is recommended that the Law and Legislative Committee support H.R.3312.

Respectfully submitted,



Steve Lakich
Director of Employee Relations

APPROVED:



Jack R. Crist
Deputy City Manager

Attachment

March 10, 1988
All Districts

PE	03/10/88	09/10/87	96.603	33.97
PF	03/17/88	03/19/87	94.257	57.43
PG	03/24/88	10/05/87	96.642	33.58
PH	03/31/88	10/01/87	96.547	34.53
PJ	04/07/88	10/08/87	96.481	35.10
PK	04/14/88	04/16/87	94.014	59.86
PL	04/21/88	10/22/87	96.355	36.45
PM	04/28/88	10/29/87	96.977	30.23
PN	05/05/88	11/05/87	96.845	31.55
PP	05/12/88	05/14/87	93.367	66.33
PO	05/19/88	11/19/87	96.800	32.00
PR	05/26/88	11/27/87	96.928	30.72
PS	06/02/88	12/03/87	96.906	30.94
PT	06/09/88	06/11/87	93.387	66.13
PU	06/16/88	12/17/87	96.739	32.61
PV	06/23/88	12/24/87	96.724	32.76
PW	06/30/88	12/31/87	96.805	31.95

[¶ 6337] Notice 88-8. I.R.B. 1988-4, January 11, 1988.

[Code Sec. 457]

Deferred compensation: State plans: Nonelective plans.—The IRS has determined that a nonelective deferred compensation plan maintained by a state or local government or tax-exempt organization will not be subject to the provisions of Code Sec. 457 for taxable years of employees beginning before January 1, 1988. Also, a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay or death benefit plan maintained by a state or local government or a tax-exempt organization will not be subject to the provisions of Code Sec. 457 for taxable years of employees beginning before the issuance of guidance describing the extent to which these forms of compensation are subject to Code Sec. 457. The exemption applies to such plans whether they are elective or nonelective. Back reference: ¶ 2899M.21.

Section 457 of the Internal Revenue Code, as amended by the Tax Reform Act of 1986, provides that amounts of compensation deferred under certain "eligible deferred compensation plans" maintained by state and local governments and tax-exempt organizations are only included in a participant's, or beneficiary's, gross income in the taxable year in which the compensation is paid or otherwise made available to that individual. In general, where the plan is not an "eligible deferred compensation plan", the amounts deferred are included in the individual's gross income in the first taxable year of the individual for which there is no substantial risk of forfeiture. Question and answer 26 in Notice 87-13 published in I.R.B. 1987-4, (Jan. 26, 1987) clarifies that section 457 applies to all deferred compensation plans of such employers, which may include nonelective deferred compensation plans as well as certain vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans.

The Service understands that prior to the publication of Notice 87-13 certain state and local governments and tax-exempt organizations believed that section 457 was not applicable to any nonelective deferred compensation, vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plans. The Service is attempting to develop rules clarifying the extent to which section 457 applies to such plans.

In the meantime, the Service has determined that a nonelective deferred compensation plan maintained by a state or local government, or tax-exempt organization, will not be subject to the provisions of section 457 for taxable years of employees beginning before January 1, 1988.

In addition, the Service has determined that a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or a tax-exempt organization will not be subject to the provisions of section 457 for taxable years of employees beginning before the issuance of guidance describing the extent to which these forms of compensation are subject to section 457. The exemption applies to such plans whether they are elective or nonelective.

No inference should be drawn from this notice as to the future treatment of such plans under section 457. The Service is currently studying a number of issues raised under section 457. Further guidance will be provided on these issues.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

For further information regarding this notice, contact Rhonda G. Migdail on (202) 566-3938 (not a toll-free call).

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