



The Washington Report **BENEFITnews**

BULLETIN NO: 09-42

APRIL 9, 2009

IRS Ruling on Constructive Receipt -- Has the IRS Changed Policy?

The Internal Revenue Service recently released a private letter ruling (PLR 200914018) that appears to be contrary to its long-standing position on constructive receipt. It is unclear whether this ruling represents a change of IRS policy or is merely an inadvertent failure to follow existing policy. While it may well be time for the Service to change its position, it seems doubtful that this PLR will serve as the announcement of any such major change.

Overview

PLR 200914018 involves a situation in which an employer enters into an agreement with a representative of its employees that certain employees will have a one-time irrevocable election to waive retirement health insurance in exchange for a higher rate of pay. An eligible current employee will have to sign an irrevocable waiver of the retirement health insurance by a fixed date in order to elect the increased pay. Future eligible employees will have to sign the irrevocable waiver within 15 days of the first contracted day of work in order to elect the increased pay rate. Failure to sign the waiver by the designated date will mean that the employee will not be allowed to waive the retirement health insurance at any later date. The increased pay rate will only apply on a prospective basis.

In the private letter ruling, the head of the Health and Welfare Branch of the IRS concluded that the employees will not be in constructive receipt of income due solely to the availability of the one-time irrevocable election. The only authority cited was Treas. Reg. §1.451-2(a), which provides that constructive receipt does not apply if the taxpayer's control of the receipt is subject to substantial limitations or restrictions. The PLR 200914018 holding appears to run directly contrary to long-standing IRS positions on constructive receipt. In fact, the same IRS branch that issued the ruling has been known to have refused to issue similar rulings in the past.

Probably the most notable place where the IRS position is seen is in the proposed regulations on cafeteria plans that were issued in 2007. Those proposed regulations state, "Section 125 is the exclusive means by which an employer can offer employees an election between

taxable and nontaxable benefits without the election itself resulting in inclusion in gross income by the employees." Retiree health insurance is a nontaxable benefit and cash compensation is taxable. Therefore, the quoted sentence would seem to provide that, since the choice in the ruling was not contained in a cafeteria plan (under section 125) the mere offering of the election results in gross income to the employee regardless of which benefit is elected. See Prop. Treas. Reg. §1.125-1(b)(1).

Further, in Rev. Rul. 75-539, 1975-2 C.B. 45, the Service ruled that a choice between cash and certain accumulated unused sick leave credits that could be applied to the cost of group medical insurance resulted in constructive receipt even for the employees who did not elect the medical benefit. A similar result was reached in a technical advice memorandum in 1994 involving a choice between compensation and health insurance coverage. The Service held that that choice created constructive receipt and therefore the people who selected the health insurance coverage were in receipt of taxable income. See TAM 9406002.

Furthermore, the fact that the election is a one-time irrevocable election should not alter the IRS analysis. Under the 401(k) regulations, certain one-time elections are permitted (e.g., they do not constitute a taxable cash or deferred election in violation of section 401(k)) if the irrevocable election is made no later than the employee's first becoming eligible under the plan. Similarly, Rev. Proc. 71-19 (1971-1 C.B. 698) and Rev. Proc. 92-65 (1992-2 C.B. 428) allow nonqualified deferred compensation elections to be made so long as they are made before the beginning of the "period of service" for

which the compensation is payable. However, under the facts of PLR 200914018, the timing of the irrevocable election does not appear to satisfy either of these requirements as it can be made after the employment commences (even though the rate of pay increase would be prospective).

Because of all the Revenue Service precedent to the contrary, this private letter ruling is, at the least, surprising. The reference to the regulations under section 451 suggests that its drafters thought that forgoing retiree health insurance was a substantial detriment that would justify the "no constructive receipt" conclusion. However, the Service has never taken that position in the past, with the limited exceptions of stock appreciation rights plans. See Rev. Rul. 80-300, 1980-2 C.B. 165.

Because of the failure in the ruling to cite the prior precedents or to make any serious attempt to distinguish them, it can be surmised that the holding was inadvertent and does not signify a change of position. On the other hand, it should be recognized that the IRS has a long history of losing cases on constructive receipt -- in fact, it has not really won any victories on this issue for over 30 years. While it may well be time for the Service to change its position, it seems doubtful that this private letter ruling will serve as the announcement of any such major change. As a consequence, readers are advised to be wary of PLR 200914018's significance and not to rely on it without consultation with counsel.

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