Tax Management
Compensation Planning Journal™

Bloomberg BNA

Leave and Learn: Paid Time Off Challenges

By Yelena F. Gray, Esq.[1]

INTRODUCTION

While for labor and employment lawyers, vacations, sick and personal time, compensatory time and other permutations of paid leave are a daily reality, ERISA and tax attorneys come across vacation policies and various and sundry paid leave arrangements more often in the context of transactions. Typically, these are run-of-the-mill use-it-or-lose-it policies where employees forfeit any unused vacation and sick time at the end of the year. Plain vanilla vacation policies rarely give heartburn to transactional attorneys. Vacations are primarily addressed in deal documents to ensure that the buyer recognizes vacation entitlements in the year of acquisition. In some instances, the buyer agrees to credit service with the seller for purposes of higher vacation accruals under the new employer's policies.[2]

Tax treatment of vacation and other paid time off rarely becomes an issue, particularly where employees must use their paid time off allotment by year end or forfeit it. Once, however, paid time off (PTO) policies venture further afield (e.g., by permitting carryover of unused time to the next year, purchase of additional time off, PTO cash-outs or contributions of PTO to welfare plans), architects of the policies and employers sponsoring them should pay closer attention to avoid negative tax consequences for both the employer and the employees. This article examines the tax treatment of PTO and addresses some of the pitfalls to be avoided.

PTO POLICIES, IN GENERAL

Under a typical PTO policy, employees accrue paid time off ratably throughout a year and must schedule time off during the same year or forfeit it at the year end. Some policies are more generous and cash out unused vacation time at the end of the year. Vacation or sick pay under these policies is taxed currently.[3] Quite a few employers, however, still maintain PTO

[1] Yelena F. Gray is a Partner with the law firm of Ungaretti & Harris in its Chicago, IL office. Yelena is a member of the firm's Employee Benefits and Executive Compensation Practice Group and leads its health and welfare benefit plans practice. Yelena also has experience in advising clients in matters involving qualified retirement plans, including plan design and drafting, monitoring compliance with new legislation and regulatory guidance, communicating with regulatory agencies, and counseling on issues of fiduciary responsibilities. In addition, Yelena has experience in advising clients regarding executive compensation plans, including matters of compliance with the requirements of §409A of the Internal Revenue Code of 1986, as amended (Code), and issues found in change in control and severance agreements, as well as equity and incentive compensation arrangements. All section references herein are to the Code and the regulations thereunder, unless otherwise indicated.

[2] Parties often overlook state law requirements to pay accrued unused time off at an employee's termination of employment. In an asset sale, this means that the seller must pay out all unused vacation time. The buyer, in that instance, would have to provide unpaid time off to employees or incur an extra expense in providing vacations. What happens in reality in many instances is that unused vacation time does not get cashed out in violation of applicable state wage and hour laws.

[3] *See* §§61(a)(1) (general inclusion of employer-provided vacation in an employee's gross income), 451(a) (inclusion in the year actually or constructively received).

policies that allow employees to carry over unused accruals to another year, subject to specified caps. At times, these arrangements permit substantial amounts to be banked and, if unused, cashed out at termination. Some arrangements go even further and allow annual cash-outs of a specified amount of vacation time. In structuring these arrangements, employers should be careful to avoid constructive receipt issues. Although less likely, PTO arrangements may in fact be considered deferred compensation, potentially giving rise to penalties under §409A.[4]

BONA FIDE VACATION LEAVE, SICK LEAVE, COMPENSATORY TIME — PTO ARRANGEMENTS

Bona fide vacation time, sick leave and compensatory time off do not constitute deferred compensation for purposes of §409A.[5] To date, the IRS has not issued guidance on what constitutes a *bona fide* sick or vacation leave program. In private letter rulings, however, the IRS listed some of the factors it would take into account in determining whether a program is *bona fide*, including whether: (1) the amount of leave available to employees annually or in the aggregate is excessive; (2) the program is broad-based or collectively bargained, or, on the contrary, available only to a limited number of employees; and (3) there is a reasonable expectation that employees will be able to use all of the leave provided under the program.[6]

In Rev. Rul. 2009-31,[7] the IRS gave examples of PTO arrangements, which the IRS assumed for purposes of the ruling to be *bona fide* vacation or sick leave. The fact that the IRS did not challenge the leave policies' status as *bona fide* in deciding whether unused time off under these policies could be contributed to a §401(k)[8] profit sharing plan gives a certain degree of comfort to employers with similar arrangements. In the first scenario, the policy provided up to 240 hours of paid time off to employees, accumulating ratably each year, without any carryover to the next year. The policy was amended so that any unused leave remaining at the end of any year could be forfeited, and the dollar equivalent of the forfeited time contributed to the §401(k) plan as a nonelective contribution. To the extent that the total contribution to a §401(k) plan exceeded the §415 limit,[9] any excess PTO amount was to be cashed out by February 28 of the following year.

In the second scenario, the PTO policy permitted employees to carry over up to a specified number of hours to the next year, with the remainder being cashed out in February of such year. The policy was then amended to permit employees to contribute the dollar equivalent of some or all of the unused time off (up to the §415 limitations) to a §401(k) plan and receive the remainder in cash.

The IRS determined that neither arrangement, as amended, caused the PTO policy to lose its character as *bona fide* vacation or sick time for purposes of §409A. In a companion revenue ruling,[10] the IRS similarly assumed *bona fide* status of the PTO policies under which employees received a cash payment for any accumulated unused time off remaining in their PTO bank within 60 days after their employment terminated. The policies were modified to permit unused time off to be contributed (on a mandatory basis, with no employee discretion in one scenario, or pursuant to an employee's election in the other scenario). These contributions were to be made shortly after an employee's termination of employment.[11] The modifications, according to the IRS ruling, did not affect the policies' *bona fide* status for purposes of §409A.

The question is then: What type of policy and at what point would a policy overstep the bounds for *bona fide* status? Supposedly, an overly generous policy, particularly one available to a select group (e.g., senior management) that permits substantial carryovers would raise a few eyebrows. Outside of those types of scenarios, vacation, personal and sick leave policies are probably safe.

Section 409A Consequences. Yet, what are the consequences of losing the *bona fide* leave attributes? As discussed in more detail below, some PTO policies still permit annual cash-outs. It is not uncommon to see a policy that provides employees with the ability to cash out up to a certain number of hours accumulated in their PTO bank at the end of each year. For

---

[4] §409A was added to the Code by §885 of the American Jobs Creation Act of 2004, P.L. 108–357, on the heels of the Enron collapse. It provides in general that unless certain requirements are satisfied, amounts of deferred compensation are includible in gross income under §409A when they are no longer subject to a substantial risk of forfeiture. Further, a 20% penalty tax is imposed on the entire amount accrued (with some exceptions), plus interest on tax underpayments at the federal underpayment rate plus 1%.

[5] Treas. Regs. §1.409A-1(a)(5).

[6] PLR 200351002. *See also* PLR 200450010 (IRS considered sick, vacation and compensatory leave policies of a governmental employer. The terms of the policies were subject to collective bargaining and permitted cash-outs of future accruals of PTO).

[7] 2009-39 I.R.B. 395.

[8] Section 401(k) provides for a cash or deferred arrangement that allows employees to direct a portion of their remuneration to a plan qualified under §401(a) and defer taxation on contributed amounts until they are distributed from the plan.

[9] §415(c). The Code limits the amount of contributions and forfeitures (annual additions) that may be contributed to a qualified defined contribution plan in any plan year. This amount is adjusted for cost-of-living periodically, as announced by the IRS. In 2013, the limit was $51,000. Notice 2012-67, 2012-50 I.R.B. 671.

[10] 2009-39 I.R.B. 398.

[11] In the regulations issued by the Treasury in 2007, accrued vacation pay that is payable to an employee after the date of his termination of employment, but not later than the last day of the year of termination or 2½ months after the date of termination (whichever is later), may be, at the election of the plan sponsor and as reflected in the plan document, included in compensation for purposes of elective deferrals and the definition of compensation taken into account under §415(c)(3). Treas. Regs. §§1.415(c)-2(e)(3)(i), 1.401(k)-1(e)(8).

ISSN 0747-8607

example, an employee could cash out up to 40 hours each year so long as he has at least an equivalent amount of PTO left in the bank after the cash-out. The employee who makes a cash-out election would receive payment equal to the number of hours forfeited multiplied by 90% of the employee's then current hourly pay rate. At the end of employment, the employee would receive payment for his unused PTO in a lump sum. If the PTO policy is found on audit not to be a *bona fide* vacation or sick leave, the arrangement would be treated as deferred compensation that provides for impermissible deferral elections or acceleration of payment for purposes of §409A.[12] For example, an employee's choice between taking time off or carrying it over from year to year would violate the timing rules under §409A, which generally require all deferral elections to be made before the beginning of the year in which the services giving rise to the compensation are performed. The time and form of payment are generally required to be designated at the time the deferral election is made.[13] The ability to receive a cash payment annually where otherwise payment would only be made at termination could be deemed to accelerate payment in a manner not permitted by §409A.[14] As a result, all accrued vacation time that was not previously taken into income would be immediately taxable, and the employee would be facing a 20% additional tax on the amount of pay deferred and interest on the underpayment of tax.

Section 457 Consequences. If a tax-exempt employer[15] maintains a PTO policy that fails the *bona fide* leave test, the policy would be within the §457(f) regime. Section 457(f)(1) provides that in the case of a plan of a tax-exempt employer (or a governmental employer) that provides for a deferral of compensation (if such plan is not an eligible deferred compensation plan under §457(b)), the compensation will be included in the gross income of the plan participant for the first taxable year in which there is no substantial risk of forfeiture of the right to such compensation. Section 457(e)(11)[16] excludes from the §457 purview ''any *bona fide* vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan.'' If the policy cannot withstand the scrutiny to come under the exemption, it would be taxed in the year that the accumulated pay is no longer subject to a substantial risk of forfeiture (i.e., as it accrues). This means that any time off would be taxed immediately, whether or not the employee takes time off, elects to receive a cash payment or carries it over to the next year. Further, the §409A rules and penalties may also apply.

Constructive Receipt. When all is said and done, most PTO arrangements would most likely be *bona fide* leave. Other issues, however, may still be lurking in the background for PTO policies. Large employers with diverse work schedules (e.g., state and local governments, hospitals and health systems) often permit employees to accumulate significant amounts in their PTO banks and use this accumulated time in various ways. Employees, for example, can use PTO not only for vacations and illness, but also for any personal reasons or to supplement their short-term disability pay. Still, work schedules simply may not allow employees to use up all of their accumulated time. Instead of forfeiting the excess or delaying its receipt until termination or retirement, employers permit employees to cash out a certain amount of time annually. Employees can choose to take time off, carry over a certain amount to the next year or cash out a portion of the accumulated time. These types of arrangements raise constructive receipt issues.

CONSTRUCTIVE RECEIPT

Compensation amounts, such as vacation pay, are included in an employee's gross income in the year the amounts are actually or constructively received, even though they might not have been reduced to the employee's possession.[17] An amount is considered to be constructively received if it is credited to an individual's account, ''set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.''[18] The Tax Court summarized the constructive receipt doctrine as follows:

> The constructive receipt doctrine requires a taxpayer who is on the cash method of accounting to recognize income when the taxpayer has an unqualified, vested right to receive immediate payment of income. [. . .] Under that doctrine, a taxpayer may not deliberately turn his back on income otherwise available. [. . .] In order to trigger application of the constructive receipt doctrine, there generally must be an amount that is due and owing which the obligor is ready, willing, and able to pay. [. . .] If a taxpayer has an absolute and unconditional right to receive income in the year earned, the constructive receipt doctrine requires the taxpayer to report such income for that year.[19]

---

[12] Treas. Regs. §§1.409A-2(a)(1), -3(j)(1).

[13] Treas. Regs. §1.409A-2(a)(1).

[14] Treas. Regs. §1.409A-3(j).

[15] A tax-exempt organization is an organization that is exempt from income tax under §501(a) and listed in §501(c) or (d). For example, §501(c)(3) is a corporation, ''and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition [. . .], or for the prevention of cruelty to children or animals.''

[16] §457(e)(11).

[17] Treas. Regs. §1.451-2(a).

[18] *Id.*

[19] *Palmer v. Commissioner*, T.C. Memo 2000-228. *See also Ross v. Commissioner*, 169 F.2d 483, 490 (1st Cir. 1948); *Amend*

ISSN 0747-8607

No constructive receipt occurs if an individual's right to receive the amount is subject to substantial limitations or restrictions.[20] Thus, unused vacation time that is available for a cash payment would be includible in the employee's gross income in the year that the employee has the right to this cash payment, whether or not he exercises this right, unless his right is subject to substantial limitations or restrictions.

Substantial Restriction or Limitation. Old case law and agency rulings show that a substantial restriction or limitation usually exists where an individual must surrender a valuable right to gain control of the amounts in question. Those rulings and judicial decisions provide an important insight into the general principles underlying the constructive receipt doctrine. In Treas. Regs. §1.451-2, substantial limitations were illustrated by certificates of deposit and similar bank-issued instruments of less than one year duration. Those instruments could have been surrendered before maturity if three months of interest were forfeited. Because interest to be earned at maturity would be significantly greater, no constructive receipt occurred with respect to earnings at the time when the certificates could have been surrendered.

In Rev. Ruls. 80-300[21] and 82-121,[22] the IRS considered the timing of income inclusion of stock appreciation rights (SAR) granted to an employee. In Rev. Rul. 80-300, a corporation granted its employees the right to a cash payment equal to the excess of the fair market value of a share of the corporation's common stock on the date of exercise of the SAR over its exercise price (i.e., the fair market value of the stock on the date of grant). The right was exercisable at least one year after the grant date and no more than 5 years after such date, at which point it was deemed exercised and the payment was made. Citing *Hales v. Commissioner*,[23] and Rev. Rul. 58-230,[24] the IRS found that:

> [t]he employee's right to benefit from further appreciation of stock, in this case, without risking any capital is a valuable right. However, once the employee exercises the stock appreciation rights, the employee loses all chance of further appreciation with respect to that stock and the amount payable becomes fixed and available without limitation. Accordingly, an employee will be in receipt of income on the date the SAR's are exercised.[25]

Rev. Rul. 82-121[26] involved a tandem stock option and SAR arrangement. Pursuant to the terms of the grant, an employee was granted a nonqualified stock option and an accompanying SAR. Whenever an employee exercised his stock option, the related SAR was forfeited and vice versa. In addition, the payment on the exercise of the SAR was limited to the purchase price of the stock option. Thus, as soon as the stock doubled in price after the grant date, the SAR could not appreciate any more. Nevertheless, the IRS found that no constructive receipt of the payment occurred at the time that the stock doubled in price. Instead, the court found that an employee would not incur any income until he exercised the SAR. The court found that a substantial limitation on the taxpayer's control over the payment existed where he ''must surrender the related options and thereby forfeit the right to benefit from any appreciation of the optioned stock in excess of the price at which the related option could have been exercised.''[27]

A line of cases that predates the Economic Recovery Tax Act of 1981 (''ERTA'')[28] (including *Hales*)[29] considered instances of substantial restrictions or limitations on the receipt of cash compensation that is deferred under a qualified retirement plan. Prior to the ERTA, the constructive receipt doctrine applied to qualified retirement plans under §401(a). In *Hicks v. United States*,[30] a participant in a profit sharing plan was found to be in constructive receipt where he elected to defer a percentage of his compensation to the plan even though he could subsequently withdraw his funds from the plan prior to his termination only upon what the court identified as a ''modest'' 5% penalty.[31] The participant, however, did not have to include in his income, until actual receipt, any of the funds that his employer contributed to the plan for his

v. Commissioner, 13 T.C. 178, 185 (1949), *acq.*, 1950-1 C.B. 1; *Young Door Co. v. Commissioner*, 40 T.C. 890, 894 (1963); *Basila v. Commissioner*, 36 T.C. 111, 116 (1961); *Hamilton Nat'l Bank of Chattanooga v. Commissioner*, 29 B.T.A. 63, 67 (1933).

[20] Treas. Regs. §1.451-2(a).

[21] 1980-2 C.B. 165, *amplified by* Rev. Rul. 80-121, 1982-1 C.B. 79.

[22] 1982-1 C.B. 79.

[23] 40 B.T.A. 1245 (1939), *acq.*, 1940-1 C.B. 2. In this case, the Board of Tax Appeals held against the IRS, finding that no constructive receipt of the value of dividends occurred where a taxpayer had the right to redeem the value of his stock in a savings and loan corporation upon surrendering his entire investment in the corporation. *Id.*, at 1248–1249 (pointing out that constructive receipt is to be sparingly applied and is not applicable unless the cash or its equivalent is unqualifiedly subject to the demand of the taxpayer).

[24] 1958-1 C.B. 204. This ruling is based on prior law applicable to qualified plans, which no longer applies, and holds that ''a requirement of a 6-month suspension from participation in an employees' profit sharing plan upon an employee's withdrawal of the employer's contributions and earnings thereon, and the employee's consequent loss of the benefit of the employer's contributions that would have been made for the 6-month period, is a substantial limitation that precludes constructive receipt of the withdrawable amounts.'' *Id.*

[25] 1980-2 C.B. 165.

[26] 1982-1 C.B. 79.

[27] *Id.*

[28] P.L. 97-34.

[29] 40 B.T.A. 1245 (1939), *acq.*, 1940-1 C.B. 2.

[30] 314 F.2d 180 (4th Cir. 1963), *aff'g* 205 F. Supp. 343 (W.D. Va. 1962).

[31] *Id.*, at 185.

ISSN 0747-8607

benefit.[32] In *Knapp v. Commissioner*,[33] on the other hand, a participant in a profit-sharing plan was not in constructive receipt of the funds in his plan account even though he could withdraw the full amount credited to him (including employer contributions) upon the completion of 10 years of service.[34] The right to withdraw the funds was not, however, unfettered. Once a participant withdrew his funds, he would have been no longer eligible to participate in the plan.[35] The court concluded that forfeiture of the taxpayer's right to receive employer contributions was a substantial limitation or restriction on the taxpayer's right to demand payment:

> The record clearly demonstrates that his right to continue to participate was a valuable one, the loss of which would have been a serious loss. It was unlike the ordinary investment. The company was annually making and was required to make substantial contributions to the credit of each participant based upon the amount of his deposits. Only by surrendering his right to further share in such contributions could the petitioner withdraw all of his participation from the fund. He had to surrender his entire right in what was obviously to him a very profitable and desirable opportunity as long as he could possibly remain a participant in it. It is difficult to conceive of a more important limitation or condition upon a right to receive money than the one which attached to the right of this petitioner.[36]

What can be distilled from the case law and several revenue rulings (which have since been obsoleted) involving pre-ERTA qualified plans is that limitations on an individual's right to demand payment are substantial where the individual stands to lose a valuable right to participate in the plan after the withdrawal,[37] forfeits an appreciable percentage of the funds or past service credits[38] or would be suspended from participation for a specified period of time.[39] Similarly, where an individual could receive a portion of his account only upon approval by the administrator after demonstrating financial hardship, the limitation was sufficient to preclude constructive receipt.[40] Notably, the revenue rulings and judicial decisions considered an individual's irrevocable agreement to postpone distribution to a specified future date as a substantial limitation or restriction that blocked the application of the constructive receipt doctrine.[41] In all instances, the forfeiture and deferment of distribution needed to be meaningful:

> Both in the penalty and deferment by prior election type of case, a penalty or period of deferment which is inconsequential lacks substance and is not deemed to prevent the participant's interest from being made available at the earliest date upon which he could have received a distribution.[42]

Without getting too far afield, it is worth noting that federal courts applied the deferment limitation quite liberally in the context of nonqualified deferred compensation plans.[43] The IRS, however, was troubled by the expansion of the ability of taxpayers to designate and change the timing of receipt of compensation without incurring adverse tax consequences. The controversy came to a head in the wake of the Enron collapse and the passage of the American Jobs Creation Act of 2004,[44] which added §409A to the Code. Although §409A did not abrogate the constructive receipt doctrine with respect to nonqualified deferred compensation arrangements, its rigid timing rules for deferral elections and distributions overshadowed the doctrine's significance.[45] This narrowing of the constructive receipt doctrine resulted, for non-exempt deferred compensation arrangements, in the abolition of ''haircuts,'' which were prevalent in such arrangements before the Enron fiasco. In essence, substantial restrictions or limitations took the form of statutory penalties, including immediate income recognition, a 20% additional tax and interest on underpaid tax.

Haircuts. As discussed above, a substantial economic penalty on the right to payment could help ward off the application of the constructive receipt doctrine. A ''haircut'' provision is one variation of the

---

[32] *Id.*, at 182–183.

[33] 41 B.T.A. 23 (1940).

[34] *Id.*, at 24.

[35] *Id.*

[36] *Id.*, at 27.

[37] Rev. Rul. 55-423, 1955-1 C.B. 41, *obsoleted by* Rev. Rul. 91-8, 1991-1 C.B. 281.

[38] Rev. Rul. 60-292, 1960-2 C.B. 153.

[39] Rev. Rul. 58-230, 1958-1 C.B. 204; Rev. Rul. 77-34, 1977-1 C.B. 276, *obsoleted by* Rev. Rul. 88-85, 1988-2 C.B. 333.

[40] Rev. Rul. 55-423, 1955-1 C.B. 42, *obsoleted by* Rev. Rul. 91-8, 1991-1 C.B. 281.

[41] *See, e.g.,* Rev. 55-423, 1955-1 C.B. 41.

[42] *Id.*

[43] *See, e.g., Martin v. Commissioner*, 96 T.C. 814 (1991). In this case, the Tax Court found a substantial limitation on the deferred compensation plan participants' ability to receive payments in connection with their shadow stock, because as a condition to payment they were required to forfeit the right to receive future contributions of shadow stock by the employer; forfeit the right to benefit from company's future equity growth without risking actual capital; forfeit the right to future payment based upon common stock dividends; and, in the case of one of the participants, forfeit all cumulative profits previously allocated to his unvested shares. The court rejected the IRS's argument that the participants constructively received their entire interest in the plan when they had the ability to receive a lump sum payment, even though they irrevocably, and before the payment was ascertainable, elected to receive 10-year installments.

[44] P.L. 108–357, §885.

[45] The requirements of §409A and the regulations promulgated thereunder are outside of the scope of this article.

ISSN 0747-8607

economic penalty concept, which permits an individual to accelerate payments while giving up a portion of the amount payable. Before ERTA,[46] haircuts were not uncommon in qualified plans and §403(b) annuity contracts.[47] On a case-by-case basis, in private letter rulings, the IRS considered various penalties on early withdrawals in such plans and found that a 10%[48] or even 6%[49] or 5%[50] haircut would be sufficient to avoid the application of the constructive receipt doctrine. It is worth noting that in some instances, smaller haircuts were imposed in conjunction with other restrictions, such as suspension of contributions for a certain period of time.[51] It is haircuts, though, that were under scrutiny, among other abuses, in the Enron scandal and in part prompted the enactment of §409A.[52] In an unfortunate turn of events, Enron rank-and-file employees were precluded from withdrawing any funds from their §401(k) plan before the collapse due to a routine blackout period that is quite common when a plan changes record keepers.[53] At the same time, Enron executives were able, using a haircut provision in their deferred compensation plan, to sell company stock held in the plan before it became worthless.

The question is whether in the post-Enron environment, 10% haircuts that were very common in years past can survive scrutiny in the context of much less controversial arrangements such as paid leave. Yet haircuts still persist, particularly in generous PTO arrangements. Many of them follow the old adage that a 10% reduction in the amount available for cash-out is sufficient to avoid constructive receipt. Others are more creative in that a deeper haircut applies to shorter-term employees. For example, a PTO policy may apply a 20% reduction in the amount payable upon an employee's surrender of accumulated time if the employee has no more than five years of service and 10% if the employee has 10 or more years of service. Whether these penalties are sufficient to delay recognition of income to the time of actual receipt of payment is anyone's guess. Using the rationale in the old cases and rulings discussed above, one should be able to argue that employees in fact surrender a very valuable right when they decide to reduce some of their saved time off for cash. Not only do they give up 10% of their surrendered paid time, but also an opportunity to receive a potentially higher amount in the ensuing years or at termination. For example, in many instances, pay in lieu of vacation is determined as a product of the employee's hourly rate and the number of hours surrendered. Even though our economy has had a bumpy ride, overall employee wages tend to rise from year to year. Long-tenured employees may see the value of their accumulated time off increase in value significantly. As discussed in more detail below, this potential for growth creates opportunities for some post-termination planning. By surrendering time off, an employee gives up these opportunities for pay growth in addition to receiving reduced pay currently. The fact that employees who elect to cash out some of their time continue to accrue vacation time in the ensuing year, at a higher rate of pay, undercuts the substantial penalty argument. Nevertheless, there appears to be no policy reason for disrupting a long-standing practice of structuring these broad-based leave policies to permit partial annual cash-outs. From the practical standpoint, employers may want to take a closer look at their generous policies. If the nature of their business does not allow employees to use most of their accrued paid time off yearly, then accumulation caps may need to be reduced and annual cash-outs may need to be mandatory. Such adjustments may also reduce the liability for vacation pay that employers carry on their books.

Employers that wish to use haircuts must be cognizant of state laws that may preclude forfeiture of vacation time. In such states, forfeiture may result in the employees filing a claim for unpaid wages.[54]

USES OF PTO

Cash-out of Future PTO Accruals. While the use of haircuts raises some concerns, annual cash-outs of paid time off can be structured in a manner that would

---

[46] P.L. 97-34.

[47] *See, e.g.,* PLRs 8241017, 8037056, 8026043, 8020145.

[48] PLR 8020145.

[49] PLR 8026043.

[50] PLR 8241017.

[51] *See id.* (a 12-month suspension from contributions accompanied a 5% haircut).

[52] *See* Arsenault & Koprowski, "The Policy of Regulating Deferral: A Critique in Light of Internal Revenue Code Section 409A," 7 *Houston Bus. & Tax L. J.* 243, 252–253 (2007).

[53] *The Enron Collapse and Its Implications for Worker Retirement Security: Hearings Before the H. Comm. on Education and the Workforce*, 107th Cong. 25 (2002). The discussion of the blackout period applicable to the §401(k) plan while executives were able to pull the money out of the plan dominates the hearing and testimony of multiple witnesses.

[54] For example, California Labor Code §227.3 provides that any unused vested vacation time must be paid at the employee's termination of employment at the then current rate of pay. For these purposes, vacation pay is deemed to be accruing as it is earned. *Suastez v. Plastic Dress Up*, 31 C.3d 774 (1982). While an employer can impose reasonable caps on accruals, it cannot cause forfeiture of the unused vacation time. *Boothby v. Atlas Mechanical*, 6 Cal. App. 4th 1595 (1992). In light of a recent decision in *Bell v. H.F. Cox, Inc.*, 209 Cal. App. 4th 62 (2012), it is not entirely clear whether unused vacation must be paid to a current employee at the then current pay rate. The court found that the rate of pay requirement applies only at termination of employment, where under the employer's policy employees were paid at a flat rate for their vacation time taken during the year rather than at their hourly rate. In Illinois, forfeiture of unused vacation time at termination of employment is also prohibited. In addition, the law provides that vacation time which is based on a length of service is earned ratably. *See* 820 ILCS 115/5; 56 Ill. Admin. Code §300.520. Therefore, it may be difficult to argue that a portion of the accrued time may be forfeited at the end of the year. Nevertheless, use-it-or-lose-it policies are permitted so long as the employee is given a reasonable opportunity to take the vacation. Ill. Admin. Code §300.520(e).

ISSN 0747-8607

not violate the constructive receipt rule. Thus, a PTO policy could permit employees to elect a portion of their paid time off to be cashed out so long as the election is made before the beginning of the year in which the time off accrues and applies only to such new accruals.[55]

PLR 200130015 involved a vacation policy maintained by a municipality. The policy permitted carryover of accrued time off to the next year, subject to certain caps. Any unused time was cashed out at termination of employment, in an amount calculated by multiplying the amount of unused time by the employee's then current rate of pay. Once the employee reached the accrual cap, he was required to use all newly accrued time by taking time off. The IRS approved an amendment to the policy that permitted employees with at least 56 carryover hours to elect irrevocably, at any time on or before December 31 of each year, to receive cash for part or all of the amount of vacation hours that would otherwise accrue in the immediately following 6-month period, up to 40 hours for each 6-month period. Any vacation time an employee actually took in the accrual year would be subtracted first from the carryover hours and then from any newly accrued time for which no election was made. Further, employees with at least 16 years of service who had reached their maximum vacation time accrual would be eligible to elect, for any 36-month period beginning in the next year, to receive any newly accrued vacation time in cash, in monthly payments, based on the then current rate of pay. This election was available only once in an employee's career. Nevertheless, the employee could once extend the 36-month period for another such period, so long as the election was made before the end of the initial 36-month period. The employee could also once in his career revoke the cash-out election.

PLR 200450010 also considered leave arrangements maintained by a municipality (a city), which offered its employees and former employees sick leave, vacation and compensatory time. With respect to employees who were members of a bargaining unit, the terms of the arrangement were negotiated with the employees' representatives. The IRS gave a nod of approval to the amendments that permitted employees to make cash-out elections under each type of program. The sick leave policy would permit employees with at least 60 hours (48 hours for bargaining employees) in their sick leave bank to elect, by December 31 of each year, irrevocably to have a portion or all of their sick days that would accrue in the ensuing year paid to them in cash, equal to a percentage of their daily salary multiplied by the number of days to be cashed out. Employees would also be able to make a similar election with respect to their future vacation time accruals. Cash payments would be made after the end of the accrual year. Notably, the IRS also ruled that the city's programs were *bona fide* vacation or sick time programs that were not subject to §457. However, before making that determination, the IRS laid out the factors it considered, which is instructive for other employers:

> (1) that the number of future sick leave days that an eligible active employee could elect to cash out in the next year is not large in relation to the large number of sick leave days that the employee is required to have and maintain in his or her sick leave bank, (2) that those City C employees eligible to elect to cash out a limited portion of their annual leave to be accrued in the next calendar year are in departments providing homeland security-type services to City C subject to possible emergency leave cancellation, (3) that the total number of annual and sick leave days offered by City C to its employees is not excessive in comparison to the number of paid time off days offered by other governmental employers, (4) that the programs are broad-based, generally being offered either to virtually all City C employees or to all employees in certain units or departments, and (5) that the plans described in this letter are not constructed in such a way as to provide a compelling reason for the employees to convert the leave time to another use. Based on these factors, we conclude that, in this case, the primary purpose of City C's program for the crediting and use of sick, vacation and compensatory time under its leave plans (including the proposed revised plans) is to provide employees with paid time off from work when appropriate because of sickness, vacation or for other personal reasons.[56]

Clearly, the IRS's concern here is that paid time off was not used as a subterfuge for deferred compensation.

Contributions to §401(k) and §457(b) Plans. As discussed above, accrued vacation pay would not be deemed constructively received if it is contributed to a §401(k) plan.[57] Note, however, that under the rules governing §401(k) plans a cash or deferred election must be between (1) cash or some other taxable benefit that is not currently available or (2) a contribution of that amount to a trust, or an accrual or other benefit, under a plan deferring the receipt of compensation.[58] Therefore, the only portion of the accrued paid time off that could be contributed to a §401(k) plan is the portion that would be otherwise paid to the employee in cash shortly after the end of the year. Thus,

[55] PLRs 200450010, 200130015.

[56] PLR 200450010.

[57] Rev. Rul. 2009-32, 2009-39 I.R.B. 398; Rev. Rul. 2009-31, 2009-39 I.R.B. 395.

[58] Treas. Regs. §1.401(k)-1(a)(3)(i).

ISSN 0747-8607

in Rev. Rul. 2009-31,[59] the first situation involved an arrangement under which any time off that was unused at the end of the year would be forfeited, and the second situation involved an arrangement under which an employee was allowed to carry over a portion of the unused time off to the next year, while the remainder was paid in cash shortly thereafter. In each case, it is the amount that would be otherwise paid in cash (whether automatically or pursuant to an employee's deferral election) that was permitted to be contributed to the §401(k) plan. The same rings true for Rev. Rul. 2009-32,[60] which approved deferral elections with respect to the unused time off that would otherwise be cashed out shortly after the employee's termination of employment.

Employees of tax-exempt or governmental employers[61] may also contribute a portion of their accumulated vacation or sick time to an eligible plan (i.e., §457(b) plan).[62] The election must be made before the first day of the month in which vacation or sick time would otherwise be paid or made available to the participant, and the participant must be an employee on the date the amounts would otherwise be paid or made available.[63] In addition, an employee who has had a termination from employment can defer a portion of his accumulated time off that is payable to him by the later of the end of the year in which his termination occurs or within 2½ months after his termination.[64] The regulations illustrate pre-termination deferrals by the following example:

> Employer X maintains an eligible plan and a vacation leave plan. Under the terms of the vacation leave plan, employees generally accrue three weeks of vacation per year. Up to one week's unused vacation may be carried over from one year to the next, so that in any single year an employee may have a maximum of four weeks' vacation time. At the beginning of each calendar year, under the terms of the eligible plan (which constitutes an agreement providing for the deferral), the value of any unused vacation time from the prior year in excess of one week is automatically contributed to the eligible plan, to the extent of the employee's maximum deferral limitations. Amounts in excess of the maximum deferral limitations are forfeited.[65]

The IRS also ruled privately that an "election to use the cash equivalent of PTO to enhance includible compensation for an elective deferral to the tax sheltered annuity, which contribution will not cause employers' year contribution on behalf of individuals to exceed the limits of §§415, 402(g) and 403(b),[66] will not be includible in gross income by reason of that election."[67] The PTO policy considered in PLR 200202027 provided each employee with an election with respect to PTO to be accrued in the following year: (1) to have the PTO taken as paid time off; (2) to have a cash equivalent of such PTO contributed to the §403(b) tax-sheltered annuity maintained by their employer; or (3) to receive a cash equivalent of the PTO as additional compensation in such following year.

Using PTO to Pay for Medical Coverage — Paid Leave and Cafeteria Plans. As with regular salary or wages, employees can completely shelter a portion of their accumulated PTO from income inclusion[68] and employment taxes by using it to pay premiums for medical coverage or reimburse medical expenses. For example, paid time off is treated as cash for purposes of a cafeteria plan under §125 and can be used to pay for medical coverage or other qualified benefits.[69] An employee must make his election with respect to a qualified benefit before the earlier of (1) the date when taxable benefits are currently available; or (2) the first day of the plan year (or other coverage period).[70] Note that for purposes of determining whether a benefit is currently available, it is irrelevant whether the benefit was constructively received pursuant to §451.[71] Rather, "a taxable benefit is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable benefit at the employee's dis-

[59] 2009-39 I.R.B. 395.

[60] 2009-39 I.R.B. 398.

[61] For purposes of §457, these "eligible employers" include such employers as a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state, or any other organization (other than a governmental unit) exempt from tax under subtitle A of Title 1 of the Code. §457(e)(1).

[62] Treas. Regs. §1.457(b)-4(d).

[63] Treas. Regs. §1.457(b)-4(d)(1).

[64] *Id. See also* Treas. Regs. §§1.415(c)-2(e)(3)(i) and 1.401(k)-1(e)(8) that define compensation from which deferrals can be made to include amounts of accrued vacation pay that is payable to the employee shortly after his termination of employment.

[65] Treas. Regs. §1.457(b)-4(d)(2), *Ex. 3*.

[66] Section 403(b) provides for deferrals of compensation to an annuity or contract purchased on behalf of an employee by entities exempt from tax by §501(c)(3), governmental employers for employees of educational institutions, or for ministers by ministers or their employers. §403(b)(1)(A).

[67] PLR 200202027.

[68] This article focuses on the federal income tax consequences of PTO. State tax implications are outside of the scope of this discussion.

[69] Section 125 provides an employee with a choice between taxable benefits (including cash) and at least one qualified benefit (e.g., payment of premiums for medical coverage). *See* Prop. Regs. §1.125-1(a)(2), 72 Fed. Reg. 43938, 43946 (8/6/07). Unused sick and vacation days can be used during leave under the Family and Medical Leave Act to pay health insurance premiums. Treas. Regs. §1.125-3, Q&A-3(a)(1)(ii).

[70] Prop. Regs. §1.125-2(a)(2).

[71] Prop. Regs. §1.125-2(a)(3).

ISSN 0747-8607

cretion."[72] The proposed regulations use a concept similar to that found in the §451 regulations, by stating that a "taxable benefit is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the benefit currently."[73] The regulations proceed to say, more expansively, that "a benefit is not currently available as of a date if the employee may under no circumstances receive the benefit before a particular time in the future."[74] Mainly, salary reduction elections under this rule are permitted to be made before the beginning of the year for which the election is made (commonly, during an open enrollment season). However, midyear election changes are permitted if certain events occur (e.g., a reduction in hours of employment).[75]

The interaction of these rules with respect to accumulated unused paid time off can be demonstrated by the following example. An employee who is retiring is entitled to have a cash equivalent of his accumulated time off paid to him within 60 days after he separates from service. Before his termination, an employee makes an election to use a portion of his accumulated PTO to purchase supplemental health insurance, not to exceed the amount of premium that could be charged for the remainder of the year in which the employee retires.[76] Another example would be an employee who is electing COBRA healthcare continuation coverage. The employee would be able to apply a portion of his accrued PTO (assuming he makes his election before it is payable to him in cash) to pay COBRA premiums for the remainder of the year. It is not entirely clear whether an employee would have the same ability to use accumulated paid time off if the arrangement were providing for annual cash-outs. The question is whether a portion of the vacation pay that was subject to the cash-out had already become "currently available" for purposes of §125.

Constructive Receipt and Anticipatory Assignment of Income. Another doctrine comes into play when an employee is trying to transfer accumulated amounts of PTO to a medical reimbursement account[77] to be used solely for payment of expenses for medical care for the employee, his spouse and other dependents. The IRS indicated that such an election would be an anticipatory assignment of income. The doctrine of anticipatory assignment of income precludes elections by employees to contribute a portion of their accumulated PTO to an HRA or a VEBA.[78] Generally, a gratuitous anticipatory assignment of income does not shift the burden of taxation and the donor is taxable when the income is received by the donee.[79] In PLR 9227035, the IRS opined:

> If an employee elects to convert excess sick leave to the Plan, where the option also exists to receive cash remuneration for the excess sick leave at some future date, the employee is merely assigning future income (the cash value of the excess sick leave) for consideration (Plan medical expense coverage). Thus, the Plan medical expense coverage is a substitute for an amount the employee would otherwise receive as compensation and the employee realizes income as if he or she had collected the cash value of the excess sick leave and paid it over to the Plan, notwithstanding that the income may be used to purchase a nontaxable benefit.[80]

However, other mechanisms are available to use accumulated PTO to fund medical reimbursement accounts.

Funding VEBA Trusts and HRAs. The general principle for the use of accumulated unpaid time off for purposes of funding a medical reimbursement plan was laid out in Rev. Rul. 75-539.[81] This revenue ruling considered two collective bargaining contracts that proposed to use a portion of the retiring employees' unused sick leave credits to fund a medical reimbursement account. The accounts under both proposals were to be used to pay premiums for retirees' medical coverage under the employer's plan. Contract A permitted retiring employees to elect a cash payment equal to ½ of the value of unused sick leave credits in excess of 50 or have the equivalent amount transferred to the medical account. Contract B called for ¾ of the unused sick leave credits to be deposited into an escrow account and used solely to pay for the retirees' cost of continuing participation in the employer's plan. Employees did not have any choice to receive these amounts in cash. The IRS ruled that un-

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] Treas. Regs. §1.125-4.

[76] *See, e.g.,* CCA 200015021, in which the IRS, while declining to rule on issues relating to a §125 plan, provides general information to the governmental employer that would help achieve the desired goal.

[77] This could be either a health reimbursement account (HRA) or a voluntary employee benefit association (VEBA). An HRA is an arrangement that: (1) is funded solely by the employer; (2) reimburses the employee for medical care expenses (as defined under §213(d)) incurred by the employee and his spouse and dependents; (as defined in §152); and (3) provides reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods. Notice 2002-45, 2002-28 I.R.B. 93, *amplified by* Rev. Rul. 2005-24, 2005-16 I.R.B. 892; Rev. Rul. 2006-36, 2006-36 I.R.B. 353, and *modified by* Notice 2007-22, 2007-10 I.R.B 670. A VEBA is a funding vehicle, exempt from tax under §501(c)(9) that provides sick, accident and certain other benefits to its members and funded either by employee or employer contributions or a combination of both.

[78] PLR 9227035. *See also Helvering v. Horst*, 311 U.S. 112 (1940); *Lucas v. Earl*, 218 U.S. 111 (1930); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958).

[79] PLR 9227035.

[80] *Id.*

[81] 1975-2 C.B. 45.

ISSN 0747-8607

der contract A, the amount of the excess sick leave credits was constructively received by the employees regardless of their election to have the amount contributed to a medical account. Contributions to the medical account were employee contributions that were not excludible from the employees' gross income.[82] Rev. Rul. 75-539 characterized the amounts contributed to an escrow account under contract B as employer contributions to an accident or health plan, which are excludible from the employees' gross income under §106.[83] These amounts were not constructively received because employees had no option to receive the amounts in cash.

While the amounts contributed to a medical plan (e.g., a VEBA trust) are excluded from the employee's gross income under §106, reimbursements of medical expenses from the VEBA or HRA are excluded from gross income under §105(b).[84] Thus, the entire amount contributed to the medical reimbursement arrangements would be sheltered from both federal income tax and employment taxes, including FICA and FUTA.[85]

Funding of retiree medical accounts with unused sick days and vacation accruals often becomes a subject of negotiations with collective bargaining units, particularly in the case of governmental employers. These arrangements, if structured correctly, follow the design approved in Rev. Rul. 75-539[86] by providing for a mandatory contribution of unused sick or vacation time that is available for cash-out at retirement to a VEBA trust or medical account that is then used to pay premiums for medical coverage of retirees and their spouses and dependents until the funds are exhausted.[87]

The IRS once again confirmed the validity of funding medical accounts with mandatory contributions of unused accumulated time off in the context of HRAs in Rev. Rul. 2005-24.[88] In accordance with Rev. Rul. 2005-24, an HRA that is funded in part with mandatory contributions on behalf of a retiring employee of an amount equal to the value of all or a portion of the retired employee's accumulated unused sick and vacation leave meets the requirements for tax-favored treatment under §§106 and 105(b). In accordance with Rev. Rul. 2002-45, an HRA must be "paid for solely by the employer and not pursuant to a salary reduction election or otherwise under a section 125 cafeteria plan."[89] The absence of any discretion on the part of employees whether to receive their unused paid time off in cash or contribute its dollar equivalent to a medical account is the key factor that permits employers to convert such excess amounts of pay to an employer contribution that can fund an HRA. For example, in PLR 200708006, an employer established a medical trust that the employer funded with several types of contributions, including discretionary employer contributions, contributions of all or a portion of employees' accumulated and unused vacation and sick leave upon retirement, and contributions of all or a portion of employees' annual excess vacation and sick leave that would otherwise be forfeited or paid out at year end. The employer determined, in its sole discretion, the amount of the vacation and sick leave to be contributed to the trust. The employer further determined the contribution amount applicable to vacation and sick leave accrued prior to the effective date of the plan. Under no circumstances could any employees or retirees (or their dependents) receive any unused amount in cash or other benefits. Any amounts remaining unused at the death of a retiree's spouse were forfeited. Relying on its rationale in Rev. Rul. 75-539[90] and Rev. Rul. 2005-24,[91] the IRS ruled that "[e]mployer contributions paid to Trust and payments made from Trust which are used exclusively to pay for eligible medical care expenses of retired em-

[82] The IRS indicated in the revenue ruling that employees may be able to deduct their medical premiums on their tax return. Note, however, the amounts paid to a medical account on an after-tax basis are still subject to FICA taxes, and the income tax deduction can be taken only if the individual's total medical expenses for the year exceed a statutory floor (currently, 10% of the individual's adjusted gross income for individuals not yet 65). *See* §213(a). "FICA" is an acronym for the Federal Insurance Contributions Act, codified at §§3101–3128. The tax imposed on employees each year under the FICA statutes and regulations consists of two parts — 6.2% of the yearly wages for the Old-Age, Survivors, and Disability Insurance, and 1.45% of the yearly wages for Hospital Insurance. §3101(a), (b). For tax years, beginning after Dec. 31, 2012, an additional tax of 0.9% is imposed on wages of certain higher paid individuals above a certain amount ($250,000 for married individuals, $125,000 for married individuals filing a separate return, and $200,000 for any other taxpayer).

[83] Section 106(a) provides that "gross income of an employee does not include employer-provided coverage under an accident or health plan."

[84] Section 105(b) provides that amounts received by an employee through accident or health insurance are excluded from gross income if such amounts are paid for medical care of the employee, his spouse and dependent. The exclusion would not apply to a highly compensated individual if the reimbursement arrangement discriminates in favor of such individuals. §105(h).

[85] Section 3101 imposes FICA taxes on an employee's wages. §3306 imposes taxes under the Federal Unemployment Tax Act (FUTA). For purposes of the FICA and FUTA taxes, the term "wages" means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. §§3121(a), 3306(b). However, the term "wages" does not include any payment (including any amount paid by an employer for insurance) made to or on behalf of an employee or any of his dependents, for medical or hospitalization expenses. §§3121(a)(2), 3306(b)(2). When premiums paid by an employer under policies providing hospital and surgical services are excludible from the employees' gross income under §106, the amounts paid by the employer are not subject to federal income tax withholding under §3041(a). Rev. Rul. 56-632, 1956-2 C.B. 101.

[86] 1975-2 C.B. 45.

[87] *See, e.g.,* PLRs 199902016, 9515010, 9340054, 9323006.

[88] 2005-26 I.R.B. 892.

[89] 2002-29 I.R.B. 116, Parts I & IV.

[90] 1975-2 C.B. 45.

[91] 2005-16 I.R.B. 892.

ISSN 0747-8607

ployees, their spouses and dependents are excludible from the gross income of retired employees and retired employees' spouses and dependents under sections 106 and 105 of the Code.''[92] Establishing an HRA in the manner described in PLR 200708006 may be an option to consider for employers that have long-service employees with sizable paid time off accruals that the employer is seeking to reduce without causing a forfeiture of the excess PTO amount.

Elective Paid Time Off. The prohibition on deferral of compensation under §125[93] precludes employees from using current compensation to pay for the cost of benefits in any future years.[94] The proposed regulations that were published on August 6, 2007,[95] provide several limited exceptions to this rule, including elective paid time off.[96] A cafeteria plan is permitted to give employees the ability to purchase, with elective contributions, additional paid time off.[97] To preclude deferral of compensation, the regulations establish an ordering rule under which non-elective time off is deemed to be used first, and elective time off may only be used after the non-elective time is exhausted.[98] The plan must provide for a cash-out or forfeiture of any unused elective time off by the last day of the plan year to which the election relates.[99] No carryover of the elective time off remaining unused at the end of the year is permitted. Some employers maintain an elective time off arrangement in conjunction with a policy that permits employees to elect a partial cash-out of their time off to be accrued in the succeeding year. A dual vacation buy-sell arrangement provides more flexibility to both the employees and the employer in scheduling and managing the time employees may need to take off from work for their various needs.

Leave Donation Programs. From time to time, the federal government permits employees to make charitable donations of their accrued time off under what is known as ''leave donation programs,'' which spring into existence at the time of natural disasters and other crises. The leave donation programs were first announced in the aftermath of the September 11, 2001 events.[100] Under a leave donation program, employees can elect to forgo vacation, sick or personal leave, and the employer makes a cash contribution to §170(c) organizations.[101] The IRS then does not assert that these payments constitute gross income or wages to employees and does not challenge the deductibility of these amounts by the employer under §162.[102] Payments under the leave donation programs must be made for purposes of relieving charitable needs in connection with the specific event (e.g., Hurricane Katrina or Sandy) by a specified deadline.[103] Similarly, the IRS does not assert that the opportunity to make such an election results in constructive receipt of gross income or wages for employees. Electing employees may not claim a charitable contribution deduction under §170 with respect to the value of forgone leave excluded from compensation and wages.[104] However, the IRS decided not to amend the regulations under §61 to except certain leave-based donation programs from the assignment of income doctrine.[105]

Leave-Sharing Programs. Two more exceptions from the assignment of income doctrine bear mentioning. Both exceptions permit employees to donate their paid leave to other employees.

Under a ''medical emergency'' leave-sharing program, employees (leave donors) could either surrender a portion of their paid leave to the employer or contribute such leave to the employer-sponsored leave bank.[106] Then employees who have (or have family members with) a serious medical condition may apply for additional paid time off. A medical emergency would have to require a prolonged leave of absence and result in a substantial loss of income because the employee has exhausted all paid leave that he had available to him (aside from the leave-sharing program). The employer would normally establish some parameters around the amount of leave that could be donated or requested. Under these circumstances, the value of paid leave taken by the leave recipient would be includible in gross income of the recipient and subject to FICA and FUTA taxes and federal tax withholding. The leave donor would not recognize any income in connection with the surrendered leave.

Another variation of a leave-sharing program involves donation of leave to employees affected by a major disaster,[107] declared by the President under §401 of the Robert T. Stafford Disaster Relief and

---

[92] PLR 200708006. Cf. PLR 200704005, in which an employer gave employees a 1-time irrevocable election into a medical account plan. The IRS ruled that the election resulted in the employee's constructive receipt of the unused time off that he contributed to the plan pursuant to the election.

[93] §125(d)(2)(A). In general, benefits may not be carried over to a later plan year or used in one plan year to purchase benefits to be provided in a later plan year. *See also* Prop. Regs. §1.125-1(o), 72 Fed. Reg. 43938, 43953 (8/6/07).

[94] CCA 200015021.

[95] 72 Fed. Reg. 43938.

[96] Prop. Regs. §1.125-1(o)(4).

[97] Prop. Regs. §1.125-1(o)(4)(i).

[98] Prop. Regs. §1.125-1(o)(4)(ii).

[99] Prop. Regs. §1.125-1(o)(4)(iii).

[100] Notice 2001-69, 2001-46 I.R.B. 491, *as modified and superseded by* Notice 2003-1, 2003-2 I.R.B. 257.

[101] *Id.* Section 170(c) provides for a deduction from a person's gross income of a contribution to a tax-exempt organization so long as the contribution is made for charitable purposes enumerated in §170(c)(2)(B) (subject to certain limitations).

[102] *Id.*

[103] Notice 2005-68, 2005-40 I.R.B. 622 (Hurricane Katrina relief); Notice 2012-69, 2012-51 I.R.B. 712 (Hurricane Sandy relief).

[104] Notice 2012-69, 2012-51 I.R.B. 712.

[105] Notice 2003-1, 2003-2 I.R.B. 257.

[106] Rev. Rul. 90-29, 1990-1 C.B. 11.

[107] Notice 2006-59, 2006-28 I.R.B. 60.

ISSN 0747-8607

Emergency Assistance Act.[108] Unlike the leave-sharing program described in Rev. Rul. 90-29,[109] this program does not allow donation of paid leave to a specific employee. It requires all donations to be completed by a stated date and used only for the benefit of leave recipients that were affected by the specific major disaster. Any unused leave would have to be returned to leave donors proportionately to their contributions. If the program conforms to the parameters outlined in Notice 2006-59,[110] the IRS would not assert that leave donors realize any income or wages for the amounts of donated leave. Leave recipients must recognize income in connection with their receipt of the donated leave for all purposes (including FICA and tax withholding).

It appears that the IRS requires leave-sharing programs to adhere to one of the exceptions strictly. For example, leave donated for the benefit of survivors of correctional guards or highway patrol officers who die while in service would be included in the leave donor's gross income under the assignment of income doctrine.[111] Similarly, leave donations available to employees who experience "catastrophic casualty losses" due to a terrorist attack, fire or other natural disaster (i.e., hurricane, flood, tornado or other highly destructive storm) would not shift income from the leave donor to the leave recipient.[112]

CONCLUSION

Vacation, sick and personal time remain an important component of overall compensation that employers offer their employees. So long as such arrangements are broad-based and designed primarily to serve the intended purpose of providing time off from work they would likely pass the *bona fide* vacation and sick leave test under §§409A and 457. Nevertheless, employers should be cognizant of the constructive receipt doctrine when they structure leave arrangement with cash-out features. An employee's unfettered right to cash out all or a portion of the accrued time off would result in constructive receipt of such time off whether or not the employee exercises his right. To prevent constructive receipt, the arrangement should impose a substantial penalty on the cash-out that could withstand scrutiny as a substantial limitation or restriction for purposes of §451. Employers should definitely consult their legal counsel before implementing haircut features in their paid leave programs. Employers who look into reducing significant accruals of paid time off could modify their programs to contribute a portion of such time to a health reimbursement account (a VEBA trust or HRA). In doing so, employers should not give employees any choices in disposing of the excess time off in this manner and must not provide employees with the ability to receive such excess in cash or in the form of any other benefit. Employers that would like to give their employees the ability to manage the amount of leave available to them during the year could also implement a buy-sell arrangement. The elective time portion of this arrangement should be implemented in accordance with the cafeteria plan requirements under §125. One other point to keep in mind is that PTO policies that permit employees to use their time off for any purposes, including periods of illness and disability, may be treated under state law as vacation time. Some states prohibit forfeiture of vacation time and impose other restrictions that employers may wish to avoid.

[108] 42 USC §5170.

[109] 1990-1 C.B. 11.

[110] 2006-28 I.R.B. 60.

[111] PLR 200626036.

[112] PLR 200720017.

Statement of Ownership

Tax Management Compensation Planning Journal (publication number 746–910), published Monthly (12 issues annually) at 1801 South Bell St, Arlington, VA 22202–4501 and having headquarters and general offices at 1801 South Bell St, Arlington, VA 22202–4501. The annual subscription price is $955.00.

Publisher, The Bureau of National Affairs Inc., 1801 South Bell St, Arlington, VA 22202–4501; Executive Editor, George R. Farrah, CPA; Editor, Shaun L. Terrill.

Owner: Bloomberg LP, 731 Lexington Ave, New York, New York 10022

Issue Date for circulation data below: 8/2/2013

	Average No. Copies Each Issue During Preceding 12 Months	No. Copies Of Single Issue Published Nearest To Filing Date
A. Total Number of Copies (Net Press Run)	587	550
B. Paid Circulation (By Mail and Outside the Mail)		
(1) Mailed Outside-County Paid Subscriptions Stated on PS Form 3541 *(Include paid distribution above nominal rate, advertiser's proof copies, and exchange copies)*	323	308
(2) Mailed In-County Subscription Stated on PS Form 3541 *(Include paid distribution above nominal rate, advertiser's proof copies, and exchange copies)*	0	0
(3) Paid Distribution Outside the Mails including Sales Through Dealers and Carriers, Street Vendors, Counter Sales, and Other Paid Distribution Outside USPS®	93	87
(4) Paid Distribution by Other Classes of Mail through the USPS (e.g. First-Class Mail®)	2	3
C. Total Paid Distribution *(Sum of 15b(1), (2), (3), and (4))*	418	398
D. Free or Nominal Rate Distribution *(By Mail and Outside the Mail)*		
(1) Free or Nominal Rate Outside-County Copies included on PS Form 3541	0	0

ISSN 0747-8607

Tax Management Compensation Planning Journal (publication number 746–910), published Monthly (12 issues annually) at 1801 South Bell St, Arlington, VA 22202–4501 and having headquarters and general offices at 1801 South Bell St, Arlington, VA 22202–4501. The annual subscription price is $955.00.

Publisher, The Bureau of National Affairs Inc., 1801 South Bell St, Arlington, VA 22202–4501; Executive Editor, George R. Farrah, CPA; Editor, Shaun L. Terrill.

Owner: Bloomberg LP, 731 Lexington Ave, New York, New York 10022

Issue Date for circulation data below: 8/2/2013

	Average No. Copies Each Issue During Preceding 12 Months	No. Copies Of Single Issue Published Nearest To Filing Date
(2) Free or Nominal Rate In-County Copies included on PS Form 3541	0	0
(3) Free or Nominal Rate Copies Mailed at Other Classes Through the USPS (e.g. First-Class Mail)	0	0
(4) Free or Nominal Rate Distribution Outside the Mail *(Carrier or other means)*	107	95
E. Total Free or Nominal Rate Distribution *(Sum of 15d (1), (2), (3), and (4))*	107	95
F. Total Distribution *(Sum of 15c and 15e)*	525	493
G. Copies not Distributed *(See Instructions to Publishers #4 (page #3))*	62	57
H. Total *(Sum of 15f and g)*	587	550
I. Percent Paid *(15c divided by 15f times 100)*	80%	81%

Publication Statement of Ownership will be printed in the 9/6/2013 issue of this publication.

I certify that the statements made by me above are true and complete. (signed) Jesse E. Copeland, Supervisor, Mailing Services, 10/1/2013

ISSN 0747-8607