Are Your Leave Policies Creating Unintended Tax Issues? Part II: Leave Cash Out

By Jessica Summers

SUMMARY: When structuring their benefits, employers often include policies on the cash-out of accrued but unused leave. However, employers tend to be unaware of the tax implications, and headaches, that can be generated by their leave cash-out policies.

The tax concern that arise with respect to leave cash out policies are similar to those that discussed in our earlier blog on leave donation policies. Specifically, with regard to leave cash out policies, the issues center on <u>when</u> paid leave becomes taxable to an employee.

A cash out program is any program or policy under which employees receive pay in exchange for unused leave. The cash out could be automatic – for example, employees are permitted to rollover x number of unused leave hours per year and are automatically paid out for any leave over the rollover cap. Alternatively, the cash out could be voluntary – for example, employees have the option to cash out some or all of their leave on the last day of the year or save and carry some or all of it over to the next year. The tax issues arise with voluntary cash out programs.

The IRS has consistently taken the position that if an employee has the option to cash out paid leave, the employee is in “constructive receipt” of the paid leave at the time that the employee could receive the cash – even if the employee doesn’t cash out – and that, therefore, the value of the leave is included in the employee’s taxable income (for example, see IRS Letter ruling 9009052). Taking the example where employees have the option to cash out some or all of their leave on the last day of the year or save it and carry some or all of it over to the next year – because each employee has the opportunity to take the cash for the leave on December 31, the value of the leave would be taxable income to the employee on December 31, even if the employee chose not to cash the leave and to keep it for the next year. To make things more complicated, this would mean that not only would the employer need to include the value of the leave in the employee’s taxable income in year 1, the employer would also need to track and exclude the value of the leave when the employee takes it or cashes it out in year 2 (because the employee has already been taxed on it).

So how can this tax headache be avoided? The simplest way is to make the cash out automatic, so employees don’t have a choice as to whether they will receive a cash out (and therefore don’t have the option to carry over leave they could have cashed to be used in another tax year). That said, some employers want to provide employees with the option to cash or carry their leave, particularly at yearend. There are employers that have tried to avoid the constructive receipt issue by only allowing employees to cash out their leave at a reduced rate (for example, employees only get 80% pay when the leave is cashed instead of used). However, the IRS has never confirmed this such approach works and there is a good chance that, if faced with the question, the IRS would disagree. The other approach that also has not been reviewed by the IRS, but which fits more soundly within the IRS’s reasoning on the issue, is to have employees elect before the beginning of the year whether they will cash out or rollover their leave at the end of the year. The argument would be that those employees who have previously elected to rollover their leave will not have the option to cash their leave out at the end of the year and will therefore never be in constructive receipt of it. Again, while this may be a feasible approach backed by a good argument, it has not been blessed by the IRS.

As a bottom line, employers who wish to give employees the option to cash out leave (during or at the end of the year) need to be prepared to either manage the related tax issues (and explain them to employees) or to take on some level of risk by trying to utilize one of the above approaches – which have <u>not</u> been blessed by the IRS – to avoid the leave becoming taxable to the employee at the time of the cash out.