

# **Paid Leave Programs: How to Avoid a Constructive Receipt Problem**

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Practice Area: County and Municipal Governance & Government Law

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Counties have traditionally provided employees with some sort of paid leave program whereby employees would receive salary continuation on days when an employee was ill, on vacation, or celebrating a holiday. In many cases, counties would allow employees to “bank” unused leave time for future use. In some cases, employees would be granted the privilege of converting unused leave time to cash or contributing the financial value of the time to an extended health coverage benefit upon retirement. Most, if not all, aspects of a paid leave plan were bargained with unions representing the employees and became an immovable fixture within the collective bargaining agreement.

In recent years, some counties have questioned the administrative and financial viability of the traditional leave plans, which separate leave entitlements into various categories – vacation, sick, holiday, personal, bereavement, etc. Many counties began transitioning to a paid time off (PTO) plan whereby employees were allotted a specific number of days away from work without regard to the reason for the absence. But even with the transition to PTO, counties typically continued to allow employees to contribute to a “bank” of unused hours that could be converted to cash or some other benefit upon separation of employment or retirement.

With the enactment of 2011 Wisconsin Act 10, changes to traditional leave plans are no longer a mandatory subject of collective bargaining. As a result, the past four years have seen a proliferation of PTO plans implemented across the state.

Most counties are aware of the tax concept of “constructive receipt” of income for an employee. This set of rules becomes critically important in evaluating the tax consequences of the “bank” conversion or payout. In simple terms, federal tax law requires an employer to treat payments made to an employee’s “bank” as income for tax purposes if the employer also provides the employee with an option to receive the contribution as cash. For example, if an employer provides a retiring employee with a current option to apply her sick leave bank to health insurance premiums (pre-tax) or receive the value of the bank in cash, the employee is in “constructive receipt” of the money that is paid for health insurance premiums and the contribution is a taxable event – meaning it results in the employee being taxed on the value of the leave – even though the employee received no actual money.

The “constructive receipt” doctrine is taking on renewed significance as counties have created new conversion options for “extended leave,” retirement accounts, health insurance continuation, and the like, some of which have at least a limited “cash out” option. But even in situations where the cash option is limited or capped, the IRS is clear that the “constructive receipt” rule will continue to apply. For example, the IRS has determined that an annual employee option to carry over or cash out excess PTO time creates a taxable event. Specifically, because an election is available, even the employee that chooses to carry over the excess time (in lieu of cashing it out) is nonetheless in constructive receipt of the funds and, therefore, subject to tax.

The consequences for failing to faithfully adhere to the constructive receipt rules can be onerous. If an audit reveals that a county did not properly withhold, and pay employment taxes on, funds that are deemed to have been constructively received, a county may be held responsible for the employer tax, penalties and interest.

It is important to note that there are many variations and exceptions to the constructive receipt doctrine, which may or may not apply in any given circumstance. However, application of the variations and exceptions requires a detailed analysis of the facts and circumstances surrounding a PTO plan and its application.

The IRS is currently conducting an initiative focusing on benefits, and accordingly is increasing its scrutiny of public employer PTO and benefit plans. IRS agents are reviewing employer handbooks and policies made available on county, municipal, and school websites as one method of determining whether to initiate a formal audit into a public employer’s benefits practices. Therefore, we recommend that counties, and other local governmental entities, immediately review their leave or PTO plans to insure that constructive receipt is not an issue and to determine compliance with the Internal Revenue Code. As is true with most matters relating to IRS enforcement, interpretation and application of federal tax law to any specific circumstance can be tricky and counsel should be consulted to ensure that the county is placed in the best possible position if an audit is forthcoming.

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