COVID-19 has disrupted many aspects of work and play, leaving employees with canceled vacations and hesitance to schedule additional travel. As a result, employers are grappling with an unusual dilemma—managing ever-growing employee paid time off (PTO) accruals. Employers with full or partial use-it-or-lose-it PTO programs risk low staffing at year end, as employees rush to use their accrued time. The most common solutions, including cash-out, carry-forward, and leave donation and sharing programs, present potential tax complications that can be addressed through advance planning.

Cash-out and constructive receipt

PTO buyback and cash-out programs can trigger constructive receipt for employees who do not elect cash. Under the long-standing tax theory of constructive receipt, employees who are given the choice between accrued PTO and a cash equivalent generally are in constructive receipt of the cash option, regardless of the option they elect. In Private Letter Ruling 9009052, which illustrates this theory, the Internal Revenue Service concluded that employees who were able to cash in their accrued PTO at any time after accrual were subject to immediate income inclusion of the cash value of the PTO at the time of accrual. This line of rulings reflects the general rule that an employee with an unfettered right to request a current cash payment in lieu of carrying PTO is treated as if she elected to receive the cash.

Carry-forward and 409A

Programs that allow employees to carry forward unlimited accrued PTO could, under certain facts, be considered a nonqualified deferred compensation plan that is subject to Internal Revenue Code (Code) section 409A, including its written agreement and distribution timing requirements. Certain welfare benefits are excluded from Code section 409A requirements, including “bona fide vacation leave, sick leave, compensatory time, [and] compensatory time.” Treas. Reg. § 1.409A-1(a)(5). But to the extent that excessive leave accruals are allowed to be carried from one tax year to the next, the program may not be considered “bona fide,” subjecting the arrangement to the complex Code section 409A regime. Tax-exempt employers are subject to similar concerns under Code section 457(f).

Leave sharing and donation

Some employers prefer programs that allow employees to donate their excess PTO to others, either through a charitable contribution or leave banks benefitting other employees, such as employees dealing with the consequences of COVID-19. In general, these types of contributions would result in taxable income to the employee donating the PTO, discouraging the practice. However, the IRS has
provided guidelines in Notices 2006-59 and 2020-46 that, when followed, permit employees to share excess leave without triggering income inclusion, while allowing the employer to receive the tax deduction for any charitable contributions.

*Proceed with caution*

As employers begin planning for unusually high year-end leave accruals, many are considering leave buy-back, carry-forward, and donation policies. Employers should ensure these programs are structured to achieve business needs without causing unintended tax consequences for employees.

If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under Related People/Contributors or the Eversheds Sutherland attorney with whom you regularly work.