IRS Scrutinizes Public Employer PTO Plans

Oct 14 2015

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Practice Area: Compensation and Benefits/ERISA & School Law & County and Municipal Governance & Government Law

Public employers in Wisconsin 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, public employers 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.

In recent years, public employers 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 public employers 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, public employers 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.

2011 Wisconsin Act 10 provided a significant opportunity for public employers to continue to evaluate changes to their traditional leave plans as changes to those plans are no longer a mandatory subject of collective bargaining. As a result, the past four (4) years have seen a proliferation of PTO plans implemented across the state as public employers attempt to create administrative and financial efficiency.

Many public employers are aware of the tax concept of "constructive receipt" of income for an employee. 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 public employers 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.

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, municipalities, schools, 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 public employer is placed in the best possible position if an audit is forthcoming.

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