Cash Out of Paid Time Off May Be Tax Trap

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A new year often brings renewed focus on paid time off (PTO) plans. PTO plan designs run the spectrum from strict use-it-or-lose-it plans to plans that allow employees to accumulate days, months or even years of PTO over their careers. Unfortunately employers often overlook laws that prohibit or restrict certain plan designs or that create unintended tax consequences.

Allowing employees to sell unused PTO back to the company at the end of the year is one common practice that can be a tax trap for the employer and employee. If an employee is given the option to either cash out the PTO or roll it over to the next year, the IRS has ruled that the employee must be taxed immediately on the entire amount that could be cashed out even if the employee actually elects to roll over the unused PTO. Under the federal income tax 'constructive receipt' doctrine, amounts available for receipt by a taxpayer are treated as received, and taxable, even if the taxpayer elects to defer actual receipt of the amount.

Employers have several options for avoiding this tax trap. The safest plan design is one that does not give the employee a choice. The IRS has indicated in several rulings that mandatory cash outs do not create a constructive receipt problem. For employers

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wanting to provide employees with more flexibility, it is possible to avoid this tax trap with a properly structured plan design. For many employers this may involve offering elective PTO through their Code Section 125 “cafeteria” plan.

To avoid these unintended tax consequences and ensure that PTO plan design satisfies the requirements of applicable law, employers should discuss the design of their PTO plans with their employment law and employee benefits counsel.

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