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A GUIDE TO PTO CASH OUT & CONSTRUCTIVE RECEIPT

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Table of contents

What is constructive receipt?

According to the **IRS** constructive receipt occurs when a taxpayer is assumed to have received income even if the income has not yet been physically received. At the point in which the income is **made available** during the taxable year, and the individual or company has access to the funds without restrictions and can spend, redirect, or otherwise exercise control over that income, it must be declared for tax purposes. **Even if the taxpayer chooses not to do anything with the income, they still have the option, therefore constructive receipt has still occurred.**

Additionally, the **IRS** states that the phrase "made available" was added in order to make it clear that it is a right of withdrawal during the taxable year, rather than the formal setting apart or crediting of income, which causes such income to be constructively received".

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04

How does the claim of right doctrine affect constructive receipt?

While constructive receipt provides that a taxpayer is subject to tax on an item of income if they have **unrestricted** right to it, the claim of right doctrine rules the timing of income recognition. The doctrine dictates when income is taxable rather than whether it is taxable. Constructive receipt has been wedded to the claim of right doctrine as applied to cash basis taxpayers and therefore one should not be considered without the other.

The claim of right doctrine is evoked if income is received without substantial limitations or restrictions. This doctrine causes the taxpayer to recognize income even though they may not have a fixed right to the income. It requires that a taxpayer that receives income under a claim of right without restrictions include such income in gross income for the year of receipt, regardless of its method of accounting.

Generally, the doctrine should be applied even in cases where the taxpayer is not entitled to the income and may be required to return the amount received in a subsequent **tax year.**

The claim of right doctrine applies if the following three elements are met:

Receipt: In general the taxpayer should receive cash or property that constitutes income. The taxpayer's method of accounting should govern the year of inclusion when determining the inclusion of income under this doctrine. Therefore, until the income is actually or constructively received, the claim of right doctrine may not be applied for a cash method taxpayer.

Unlimited control: Typically, the taxpayer has unlimited control over the use and disposal of income. However, if the income is received without restrictions as to its use, the doctrine may apply. The determination is made upon evaluation of the extent of such restrictions and barriers to its receipt.

Asserted claim of right: The taxpayer should hold the income under an asserted claim of right. The taxpayer should generally treat the income it receives as its own in order for the doctrine to apply. Generally, the burden of showing that no claim of right exists is on the taxpayer. If amounts that have been previously included in gross income under the claim of right doctrine are later repaid, the taxpayer generally is entitled to a deduction. The year of deduction should be determined under the taxpayer's method of accounting.

Why does constructive receipt matter in relation to paid time off (PTO)?

Constructive receipt applies to all forms of payment, including property, stocks and in this case, PTO. This means that, before offering this perk to employees, employers need to understand applicable tax rules and specific state-by-state requirements. And while many employers offer PTO cash outs as a perk to attract and retain talent, employees are likely to ultimately be unhappy when confronted with unforeseen additional taxes, including potentially needing to pay income tax on the balance of unused PTO even if they have not cashed out its value.

Constructive receipt applies to all forms of payment, including PTO

How does constructive receipt affect PTO policies?

The employee's perspective:

Constructive receipt is generally applied where a cash basis taxpayer is entitled to money which is made immediately available to him and his failure to receive it is due entirely to his own circumstances.

In reference to PTO, employees may be required to recognize (and pay taxes on) vacation pay they have not yet received under the constructive receipt doctrine, which provides that income may be considered as received if it is "made available".

Therefore when an employee's benefits plan allows employees to convert unused PTO into cash, the IRS rules that they are constructively in receipt of that income **as soon as the right to receive cash for the PTO becomes an option.** Furthermore, in this case, **employees would receive a W-2 income equal to the cash value that could be requested for the PTO accrual.**

To reiterate, the tax system views the option of cashing out the value of PTO the same as actually **receiving** the cash value. Because constructive receipt determines the point at which income is delivered, the concept does not allow an employee to control when the PTO is taxable.

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How does constructive receipt affect PTO policies?

The employer's perspective:

Generally, an employer may deduct expenses related to employees' vacation pay once the employer actually pays the employee.

Under section 404(a)(5) of ERISA, it is generally accepted that compensation paid under a deferred compensation plan is deductible in the taxable year in which such amount is **included in the gross income of an employee** participating in the plan.

If PTO is paid within 2.5 months after the end of the taxable year, the employer may continue to treat that PTO expense as having been incurred in the taxable year the services were provided. As this is the taxable year in which the liability is fixed, the amount can be determined with reasonable accuracy, and economic performance has occurred. However, if payment is made beyond 2.5 months after the end of the taxable year, it is non-deductible in accordance with section 404 of ERISA and the regulations thereunder.

The determination of whether a plan defers the receipt of benefits should be made separately with respect to each employee and each amount of benefit.

Under the accrual method of accounting, a liability has occurred, and may be taken into account for tax purposes if the amount of the liability can be determined with reasonable accuracy and economic performance has occurred with respect to the liability. Economic performance occurs when the party to be compensated i.e. the employee, has done what it needs to earn that compensation.

In the case of unpaid PTO, economic performance has occurred as the employee has earned compensation through their accrued PTO.

Accordingly, there should be a **fixed amount** for the obligation/compensation and an ability to determine the amount with reasonable accuracy. The amount is usually consistent with the legal obligation.

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09

Important pitfalls to watch out for

Important pitfalls to watch out for

When companies give employees the option to cash out unused paid time off as part of their PTO policy, **employers expose their employees to constructive receipt.** Constructive receipt occurs because income can be used despite money having not yet been physically received. Thus the taxpayer, in the case of the employee, is subject to tax as though they received possession of the income because the income has been set apart, made available or credited to the taxpayer's account.

To avoid application of the constructive receipt, and tax implications for both employer and employee, a restriction on a taxpayer's (the employee's) receipt of proceeds should come into play before the taxpayer's right of receipt exists.

> ***To avoid application of the constructive receipt, and tax implications… a restriction on a taxpayer's receipt of proceeds should come into play before the taxpayer's right of receipt exists.***

How Sorbet can help you avoid invoking constructive receipt

Sorbet is a unique employee benefit that allows employees to **cash out** the unusable portion of their PTO, reducing accrued PTO liabilities for their employers and replacing it with a predictable, cost saving payable.

Sorbet's unique solution protects your employees from heightened tax risks. By cashing out through Sorbet, the PTO income is not constructively received because the employee's access to its receipt is subject to substantial limitations and restrictions, which are in this case, a fee and/or approval process. **As a result, the IRS will not recognize the cash out as constructive receipt** as there is a **meaningful barrier between the employee and the cash.**

The eligibility to cash out with Sorbet has to adhere to the employer's policy (a CFO and/or HR approval). Once determined, eligible employees log on to the Sorbet app and decide how much (if at all) of their available PTO balance they want to cash out. Sorbet provides a sufficient barrier between the employee and the process of exchanging PTO for cash because a transactional fee is charged and the actual amount cashed out is financed solely by Sorbet.

In order to avoid invoking constructive receipt the employer should be able to quantify its liability to Sorbet at the end of the tax year with reasonable accuracy. Sorbet periodically provides statements with the exact amount that was cashed out by employees on the employer's behalf in the applicable period.

The deduction may apply only with respect to the amount which is actually cashed during the employer's taxable year and within 2.5 months after the end of the employer's taxable year, as reported to the employer by Sorbet.

Sorbet is the perfect solution for eliminating constructive receipt when cashing out PTO - and has added benefits! Setting up the infrastructure to pay off your PTO liabilities in compliance with state-by-state regulations

and while adhering to applicable tax rules requires a significant operational and legal lift. With Sorbet, the legwork is already done for you, saving you time, effort and money. The best part is that it doesn't cost you anything! Not only does Sorbet eliminate the additional tax consequences, but it actually helps employers increase their tax deductions. By cashing out PTO through Sorbet, employers turn an unpredictable liability into a cost saving, tax deductible and predictable credit line, all while giving employees the freedom to choose how they want to spend their PTO.

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