IS A LEAVE SHARING PROGRAM RIGHT

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By: Kelly O. Scott and Amy Mellow
Employment Law Reporter, Ervin Cohen & Jessup LLP

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Kelly O. Scott

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During the holiday season, our thoughts often turn to giving, including giving to fellow employees impacted by medical emergencies or natural disasters. Many employers provide a means to put these thoughts into action through various company sponsored charity drives, fundraising efforts and direct donations. Perhaps a more creative and potentially effective method of assisting employees in need exists in the form of donating accrued but unused vacation leave. Particularly for employees who have reached a cap in accruing leave, the ability to give these funds to those less fortunate offers significant benefits to all those concerned. Further, a leave sharing program offers employers a low-cost way to build employee morale while providing significant assistance to valuable workers. But how does such a program work?

A basic principle of tax law is that a taxpayer's assignment to another person of his or her right to receive compensation for personal services does not relieve the taxpayer of the tax liability on the assigned income. See Lucas v. Earl, 281 U.S. 111 (1930). Despite the principle's deep roots in legal theory, recent administrative decisions have created two narrow exceptions to this long-standing rule.

The first exception concerns leave sharing when there exists an extreme need for charitable relief, such as during major catastrophes like terrorist attacks and natural disasters. The exception gains authority from Executive Notice 2006-59, which states that employees who deposit leave in an employer-sponsored leave bank are not subject to the tax and withholding liabilities in connection with the deposited leave. Plans that fall within this exception are called Employer-Sponsored Major Disaster Leave Sharing Plans.

The exception applies only to qualifying Major Disaster Leave Sharing Plans that are designed to aid employees who have been "adversely affected" by a "major disaster." The Notice defines a major disaster as: "a) a major disaster as declared by the President under §401 of the Stafford Act, 42 U.S.C. §5170, that warrants individual assistance or individual and public assistance from the federal government under that Act, or b) a major disaster or emergency as

declared by the President pursuant to 5 U.S.C. §6391, in the case of employees described in that statute." The Notice considers an employee to be "adversely affected" by a major disaster if the disaster has caused severe hardship to the employee or a family member of the employee that requires the employee to be absent from work.

The second exception allows leave sharing within a single employer. The exception gains authority from Revenue Ruling 90-29, which permits leave sharing plans that allow employees to deposit leave into an employer-sponsored leave bank for use by fellow employees who suffer "medical emergencies." Plans falling within this exception are called Employer-Sponsored Bona Fide Medical Leave Sharing Plans. The ruling applies only to qualifying plans that are designed to aid employees who suffer from "medical emergencies." The ruling defines a medical emergency as a "medical condition of the employee or a family member of the employee that will require the prolonged absence of the employee from duty and will result in a substantial loss of income to the employee because the employee will have exhausted all paid leave available apart from the leave sharing plan."

If and when an employer's plan falls within either of the above-mentioned exceptions, the employee who deposits leave into the employer-sponsored leave bank ("Donor Employee") for the benefit of another employee ("Recipient Employee") is released from all tax and withholding liabilities on the leave that he or she would otherwise be subject to under Lucas. Similarly, the Recipient Employee must include the received leave in his or her gross income, as the received leave is considered "wages" for employment tax purposes. Therefore, under either type of plan, the tax and withholding liabilities on the deposited leave are transferred from the Donor Employee who earned the leave to the Recipient Employee who uses the leave.

Given that the two administrative-based exceptions are quite narrow, employers would be wise to tailor leave-sharing programs as closely as possible to the type of plan already ruled to fall within one of the exceptions. In addition, although state tax rules typically follow federal standards, any proposed plan should be checked against any applicable state requirements. Accordingly, details regarding eligibility, authorization and use must be carefully drafted by a knowledgeable tax law professional. However, once these steps are taken and the program is established, the plan should have long-term benefits for the employer, donating employees and qualified recipients.