

MEMORANDUM OF LAW

DATE: June 20, 1994

TO: Jerry Fort, Deputy Director, Personnel Department

FROM: City Attorney

SUBJECT: Pay-in-Lieu of Benefits

BACKGROUND

By memorandum, Ken Murray and Marilyn Jones of the Wyatt Company indicate that Technical Advice Memorandum ("TAM") 9406002 issued by the Internal Revenue Service ("IRS") obligates employees to pay taxes on pay-in-lieu benefits even if those benefits are not yet received. You have asked if this TAM affects the City's pay-in-lieu of annual leave benefit program.

ANALYSIS

The facts in TAM 9406002 are clearly distinguishable from the City's pay-in-lieu of annual leave benefit. The underlying facts upon which the TAM is based indicate the employer provided the employee with an option, prior to employment, of either additional wages or paid health benefits. Those receiving health benefits received lower compensation. The health benefits at issue were not provided under the auspices of a qualified cafeteria plan pursuant to Internal Revenue Code ("IRC") section 125, and therefore enjoyed no tax exempt status. The IRS said selection of health benefits in lieu of increased salary was an example of an anticipatory assignment. Under these conditions the election of health benefits was the same as if the employee had received the cash and then assigned that amount of income to a third party.

The IRS cites *Helvering v. Horst*, 311 U.S. 112 (1940) as authority for its TAM. In that case, the Supreme Court said:

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who

has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property.

This explanation clearly illustrates the reasoning behind the TAM. The facts in that case indicate the employee had the right to receive the cash benefit and instead opted to assign the cash benefit to the third party insurance company. Through this assignment, the employee has "fully realized the economic gain represented by his right to receive income . . . ." That is, he received the benefit of the income in the alternative form of health insurance.

The facts in the TAM differ significantly from the City's pay-in-lieu of annual leave benefit. An employee who has accrued annual leave may sell that leave at any time (unless, as currently, precluded by a Memorandum of Understanding). However, the employee does not realize the benefit of the accrued leave time until the leave is converted to dollars, at which time the dollar value is taxed as ordinary income. The employee has no right to assign the accrued leave to a third party and may, therefore, enjoy the benefit only when he or she uses the leave by taking a vacation or receiving pay-in-lieu of the vacation. "From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event rather than the acquisition of the right to receive it. And 'realization' is not deemed to occur until the income is paid." *Id.* at 115.

There is also a common sense aspect to the Court's reasoning. If, as Wyatt suggests, an employee may be taxed on accrued annual leave even if it is not used or sold, that employee could conceivably be taxed on the same accrued leave in innumerable subsequent years until the leave is exhausted. Such duplicative taxation is manifestly unfair to an employee who chooses, for whatever reason, to accumulate leave credits for future use.

CONCLUSION

TAM 9406002 is applicable only to those limited situations where pay-in-lieu benefits may be assigned by the employee to a third party. In such instances, the employee enjoys the value of benefit by the anticipatory assignment of the benefit in exchange for some other benefit, such as health insurance. City employees may not assign their accrued leave to third parties except in instances when the employee donates his or her accrued leave to other employees through the City's catastrophic leave program. Catastrophic leave donations are taxable income to the donee because the donee enjoys the value of the benefit. The donor receives no benefit for his or her donation. In all other cases, accrued leave is taxable income to the employee accruing the leave at the time the benefit is realized. Since the employee may not make an anticipatory assignment, the dictates of TAM 9406002 are not implicated by the City's pay-in-lieu of annual leave benefit.

Please give me a call if you have any further questions.

JOHN W. WITT, City Attorney

By

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cc Ed Ryan

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