Are Your Leave Policies Creating Unintended Tax Issues? Part I: Leave Donation

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SUMMARY: When it comes to leave policies, most employers are focused on complying with federal, state and local leave laws and creating a competitive benefits structure. Often this includes policies on leave donation. However, employers commonly overlook the tax issues that can cause headaches for them and their employees.

The tax issue with leave donation programs center on the question of who is taxed on the donated leave.

For the purposes of our consideration here, a leave donation program is any program or policy that gives employees the option to donate their accrued but unused paid leave to another employee (whether that be a specific individual or into a pot that employees can draw from).

The bottom line rule when it comes to leave donation is that, unless the employer has a donation program that qualifies for one of the IRS's two exceptions, the leave will be subject to double taxation. First, the value of the leave will be taxable income to the donating employee at the time he or she donates it (i.e. it will be treated the same as if he or she took the leave). Further, the leave will also be taxable to the recipient employee who uses the donated leave.

So how can an employer allow for leave donation without the donated leave being treated as taxable income to the generous donor employee (who gets no benefit from the leave)? The IRS has identified two exceptions - first, for donated leave to be used for medical emergencies, and second, for donated leave to be used in the event of a major disaster.

The medical emergency exception was originally established by the IRS in 1990 (in Rev. Rul. 90-29). Under this exception, leave donated to a leave sharing program for medical emergencies will only be treated as taxable income to the recipient (not the donor) if the following conditions are met:

- The program must be in writing and create a leave bank or pool that employees can donate leave to (i.e. employees donate leave to the pool to be used by any other qualifying employees, not a specific employee).
- The program must only allow the paid leave in the pool to be accessed by employees who have exhausted all their other paid leave and who experience "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 [without the donated paid leave]." The program should have a process for requesting leave from the leave bank and confirming that leave from the leave bank is being used for a medical emergency.
- The program must set rules on how much leave an employee can donate in a given year.

The major disaster exception was set out by the IRS in 2006 in Notice 2006-59. It provides that leave donated to a leave sharing program for major disasters will only be treated as taxable income to the recipient (not the donor) if the following conditions are met:

- As with medical emergencies, the program must be in writing and create a pool that all employees can draw from (no directed contributions).
- The program must only allow an employee to draw on the leave bank if he, she or a family member encounters a severe hardship caused by a major disaster (as declared by the President) that requires the employee to be absent from work.
- The program must limit the amount of leave that an employee can donate to the pool to the amount of leave that the employee accrues during the year.
- The program must adopt "a reasonable limit, based on the severity of the disaster, on the period of

time after the major disaster occurs during which a leave donor may deposit the leave in the leave bank, and a leave recipient must use the leave received from the leave bank" and make a determination, based on need, as to how much leave an employee can take from the pool.
- The program may not provide qualifying employees with cash in lieu of leave from the pool but leave from the pool can be used to reduce an employee's negative leave balance caused by a major disaster.
- The leave donations are major disaster specific, meaning the leave donated for a specific disaster must be used in the time specified by the program for employees impacted by that disaster. Any leave not used for the specific disaster in that time gets returned to donors on a proportional basis.

As a bottom line, employers who wish to allow employees to donate leave to one another without that leave being taxable to the donor, can establish a medical emergency leave donation program, a major disaster leave donation program or both.

Employers who wish to sponsor leave sharing programs that fall outside these two exceptions may continue to do so, but should be sure that donating employees understand the tax consequences of donating leave.