

Compensatory Time in Lieu of Overtime – Options for Consideration

Provision of compensatory time in lieu of overtime may be an attractive option that counties and employees wish to consider. However, it is important to note that an employer cannot retroactively decide to treat extra hours worked as compensatory time instead of paying it as overtime. To be granted as compensatory time, the employer must first have an agreement with the employees' representative, such as that achieved through the collective bargaining process and memorialized in a collective bargaining agreement, in advance of the employees working the extra hours.

Some counties, after establishing this agreement, may allow employees who work overtime to choose between receiving overtime pay and receiving compensatory time, also referred to as comp time. Providing employees such an election, unless properly designed, can create significant taxability issues for both counties and employees alike under the tax doctrine known as *constructive receipt*.

The doctrine of *constructive receipt* is addressed in the regulations under Section 451 of the Internal Revenue Code. It requires that if a taxpayer has a current right to receive taxable income, then the taxpayer is taxed on the income currently, that is, at the earliest date the taxpayer could have received it. This is the case unless "substantial" limitations apply to the individual's right to receive the income currently. Accordingly, if an individual has an unfettered right to either receive taxable income currently or defer its payment to a later year, the individual is taxed on the income currently.

Although the Internal Revenue Service has not specifically ruled that the *constructive receipt doctrine* applies to an election between overtime pay and compensatory time, it is likely to apply in this situation because once employees have worked the overtime hours, they have a right to receive taxable income without any substantial limitation. Note, the same *constructive receipt* issues arise if compensatory time is awarded in lieu of overtime pay and employees are given the opportunity to cash out the compensatory time at any time.

Permissible Alternatives:

(1) No Choice

It is the level of control that an employee has over his or her ability to receive cash currently or defer it for payment to a future year that triggers *constructive receipt*. One alternative to avoid *constructive receipt*, then, is to simply eliminate the choice. Under this alternative, counties would structure their compensatory time policies to provide either mandatory overtime pay or mandatory compensatory time according to objective terms set out in their policies. This alternative may be less attractive to an employee, but preferable to being taxed on an amount not yet received. If compensatory time awards are mandatory, this option may be coupled with an automatic cash-out of all or a portion of unused compensatory time at specified times.

(2) Election, but Applicable to Future Compensatory Time Accruals Only

Election Year Separate from Accrual Year

In several private letter rulings related to the cash-out of accrued leave, the IRS has found that no *constructive receipt* occurs if the election between cash-outs and retaining accrued leave is made in the calendar year (the "election year") prior to the year in which the leave accrues (the "accrual year"). In

these cases, the election applies only to leave not yet “earned” and so not yet available. Accordingly, a cash-out election is permitted, and no *constructive receipt* occurs.

These private letters rulings have not addressed the choice between compensatory time and overtime pay, and private letter rulings cannot be relied upon by taxpayers other than the taxpayer who requested it. However, these rulings provide helpful insight into the IRS’s current position regarding application of the *constructive receipt doctrine*. According to the manner in which the *constructive receipt doctrine* was applied, these private letter rulings suggest if an employee makes an election in the *election year* to receive either compensatory time or overtime pay in the *accrual year* (where the *accrual year* is subsequent to the *election year*), no *constructive receipt* will occur. This option may be coupled with an automatic cash-out of all or a portion of unused compensatory time at specified times.

Election and Accrual Within Same Year

A variation of this approach is to allow employees to make the election during the *accrual year* so long as it is made before the overtime is worked. Under this approach, the election could be made any time before overtime is worked and a new election could be made by the employee prior to each time they will work overtime hours. The basis for this approach is that the requirement to work the overtime hours is a substantial limitation on the employee’s right to receive the overtime pay. Accordingly, an election made prior to working the overtime hours does not cause *constructive receipt* because the right to overtime pay is subject to a substantial limitation at the time the election is made. In light of the fact there are no analogous private letter rulings in which the IRS approved it, this approach involves more risk than the approach under which elections are made during the *election year* as described above.

(3) Election as Overtime is Worked, but with Automatic Cash-Out of Compensatory Time at End of Year

Because the *constructive receipt doctrine* is concerned with the tax year in which taxable income is received, if all compensatory time is cashed out in the year in which it is earned, the *constructive receipt doctrine* becomes irrelevant. Accordingly, counties may allow employees to choose between overtime pay and compensatory time accruals even after the overtime is worked, provided that all compensatory time elected by employees is automatically cashed out by the end of the year in which it was earned.