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August 13, 2010 | Posted By

Treatment of Accrued But Unused Vacation in Asset Deals

The treatment of accrued but unused vacation pay (hereinafter, referred to as "Vacation Benefits") in the context of selling a business has arisen in recent transactions involving clients advised by the firm's Corporate Practice Group. This gives us an opportunity to remind business owners operating in California of the landscape of the rules associated with the payment of Vacation Benefits and the practice of transferring those liabilities to the new employer in the sale of a business.

Under California law, when an employee terminates employment with his/her employer, the employer is required to pay the employee all wages owed at the time of such termination, which includes any Vacation Benefits. Furthermore, when employees of a business are transferred to a new employer upon a sale of all or substantially all of a company's assets to a third party, the sale results in the business employees terminating employment with the company, and thus, they must generally be paid out their Vacation Benefits along with wages. The unfortunate impact of this rule is that the transferred employees must start from zero in accruing vacation pay during their employment with the new employer since their Vacation Benefits were paid out upon the sale. This result is disfavored by transferred employees since they typically report to work at the same location following the sale of the business and perform the same job with the expectation of the same or comparable pay and benefits.

By way of background, the California Division of Labor Standards Enforcement (the "DLSE") is the state agency that has the authority to adjudicate wage claims, investigate discrimination and public works complaints, and enforce labor law and the Industrial Welfare Commission wage orders. ***According to the DLSE's Enforcement Policies and Interpretations Manual, it is permissible from a labor law perspective for an employer selling its business to substitute the new employer in its place with respect to the obligation for Vacation Benefits earned by transferred employees before the sale, as long as the substitution occurs with the express written consent of the transferred employees***. Thus, to comply with the DLSE's position, transferred employees must be given a choice between being paid out their Vacation Benefits upon the sale, or consenting to the new employer assuming the obligation such that the Vacation Benefits are available during employment with the new employer following the sale.

Although the practice of substituting the new employer as the obligor for Vacation Benefits with the transferred employees' consent is permissible under the purview of the DLSE, employers should be aware that the constructive receipt rules from an income tax perspective apply when an employee is given the choice between receiving cash now or a future benefit. In other words, the Internal Revenue Service would take the position that the constructive receipt rule applies when the transferred employees are given the choice between being paid their Vacation Benefits upon the sale or delaying the payment of the Vacation Benefits when the transferred employees actually takes vacation time off during employment with the new employer. The unintended result is that the Vacation Benefits are includible in the gross income of the transferred employees that consented to the "rollover" of the Vacation Benefits in the current tax year, even though the Vacation Benefits may not actually be paid until a later tax year.

In order to avoid the constructive receipt issue, it is common for the new employer of the transferred employees to obtain the express written consent of the employees by way of an acknowledgement of the "rollover" contained in the employees' offer letters. For those employees that commence employment with the new employer, they are viewed as having consented to the rollover of their Vacation Benefits. Any employees that do not accept employment with the new employer are paid out their Vacation Benefits. Employers should be aware that although this practice avoids the constructive receipt issue, it may be challenged from a labor law perspective by the DLSE because the transferred employees are technically not given the choice of having their Vacation Benefits paid out upon the sale (i.e., the rollover of Vacation Benefits is a condition of employment with the new employer).

To summarize, paying out Vacation Benefits to transferred employees in the context of a sale of a business structured as an asset deal avoids raising any issues from both a labor law and tax law perspective. If employers wish to reduce the disruption cause by a company sale by rolling over Vacation Benefits to the new employer, they should proceed knowing that there are risks involved depending on how the consent of the transferred employees is structured and obtained.

For further information, please contact one of the following members of the firm's Employee Benefits Practice Group with any questions:

Martin J. Smith (213) 617-5490

Michael Chan (213) 617-5537