

Tax Considerations for Incentive Programs and Employee Achievement Awards

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I. TAXABLE INCENTIVE PROGRAMS

The federal income tax considerations for incentive programs are often overlooked. While it is difficult to give technical tax advice that would apply equally to all incentive programs, following certain general income tax principles can make an incentive program more successful and avoid unpleasant surprises. As a general rule, incentive prizes and awards given to individuals to reward them for certain achievements are taxable as ordinary income regardless whether the prize or award is in the form of cash, merchandise or travel. Treas. Reg. § 1.74-1. Accordingly, prizes and awards are also subject to FICA (social security) and unemployment tax. Rev. Rul. 68-216, 1968-1 C.B. 413. If the prize or award is merchandise or travel instead of cash, the *fair market value* of the item must be included in income. What constitutes fair market value depends on the item and whether it is merchandise or travel.

A. Merchandise

Carlson Marketing made a survey of various merchandise items in its catalog comparing the prices of those items to the prices for the same merchandise in different retail stores. After comparing the prices in stores to the catalog point-list price, the survey concluded that a reasonable fair market value would be 70 percent of the sales (point-list) price. The 30 percent discount reflected the marketing and fulfillment services that stores do not incur and do not have to pass through to their customers. These costs include: (1) the services of the professionals who create the incentive program, (2) ongoing management of the incentive program, (3) tracking and evaluating results for the incentive program, (4) merchandising services that make available a multitude of merchandise that is popular among customers, and (5) the attention given to each order and its processing through a distribution center. Thus, in simplest terms, if the cost of a watch used as an award in an incentive program is \$250, its fair market value should be approximately \$175.

B. Travel

Determining the fair market value of travel may prove to be somewhat more complex. In an effort to come up with some guidelines regarding the value of travel awards, Carlson Marketing studied its tour costs as compared to those of outside travel agencies on selected trips, analyzed the cost of land travel for a single traveler compared to the cost of the same travel for each person who was part of a group, and reviewed group travel invoices to determine what components of cost should be included in the computation of fair market value. As a result of its analysis, Carlson concluded that a fair market value of land travel would be 73 to 76 percent of

land cost. Thus, as a general rule, a 25 percent discount should be acceptable. It also concluded that no discount was appropriate for air travel, although, presumably, the fair market value of air travel would be determined by reference to discount travel fares. If the employer or the incentive company purchases the air fare, then the purchase price of the ticket should also be its fair market value for income tax purposes. As with merchandise, the reasons for the discount of approximately 25 percent for land travel are that an individual would not incur certain costs: (1) there would be no need for a tour director, (2) there would be no need for name tags and other customized materials, (3) there would be no need for food and beverages that are provided to a group, and (4) there would be no administrative charges for special services.

C. Income Tax Reporting Requirements

If the recipient of a prize or award is an employee, the fair market value of the prize or award is wages that are reported on his or her Form W-2 and are subject to federal and state payroll tax withholding. If the recipient of the award is an independent contractor (a dealer, distributor, independent sales representative, and so forth), the fair market value of the award is reported on his or her Form 1099-MISC, unless the aggregate value of all compensation to the individual is less than \$600 in the calendar year. The payer is not required to issue Form 1099 to a corporation. The Internal Revenue Service (“IRS”) does not require withholding of payroll taxes for independent contractors. As a general rule, the recipient of an award is deemed to have received it for income tax purposes when it is credited to his or her account, set apart for him or her, or when it is made unconditionally available to him or her. Treas. Reg. § 1.451-2. Therefore, as a practical matter, the prize or award could be deemed to be taxable to the employee or independent contractor as soon as he or she can use it without substantial restrictions or limitations (*i.e.*, upon receipt).

D. Conclusions and Some Observations

The percentages set forth above are only guidelines that an employer or any other person giving prizes or awards may use in determining the fair market value of merchandise and travel awards. The studies by Carlson are its attempt to interpret technical IRS regulations regarding valuation. Each employer or other taxpayer is entitled to determine the fair market value of prizes or awards, as long as its methodology is defensible. Nonetheless, awards given in the form of travel or merchandise instead of cash or cash equivalents may well be preferable for tax as well as business reasons. One tax advantage of merchandise or travel is that its fair market value for purposes of reporting on Form W-2 or 1099-MISC may be lower than its cost to the employer. Thus, the amount of tax payable by the recipient would be lower than if cash were used. Cash awards cannot provide any such tax savings to the recipient. In addition, merchandise has the added non-tax benefits of providing continued motivation and encouraging saving for a reward (the recipient can earn points for a more valuable prize and then can use that prize, whether it be a watch, toaster, or golf clubs, for years), creating emotional attachment for the recipient or having “trophy” value (the recipient can point to having *earned* something tangible), and requiring the recipient to visualize a prize and work toward receiving it. On the other hand, an employee or independent contractor may view cash simply as additional pay that

can be relatively insignificant. Moreover, an employee or independent contractor may also see a cash award as part of his or her compensation, which may create a disincentive if it is not received in later years as well.

II. EMPLOYEE ACHIEVEMENT AWARDS

A. Definition

Section 274(j) of the Internal Revenue Code contains specific rules on the tax treatment of “*employee achievement awards*.” As a general rule, the employer cannot deduct employee achievement awards, unless they meet certain criteria. An employee achievement award is defined as an item of “*tangible personal property*” that an employer gives to an employee for length of service or safety achievement. The award must be given as part of a *meaningful presentation* and under such conditions that it does not amount to disguised compensation. For example, an incentive award will not qualify for favorable tax treatment if it is given at the same time that annual salary adjustments are made, or if it is used as a substitute for a program of awarding cash bonuses. If certain other statutory conditions are met, an employer may *deduct* the cost of *employee achievement awards* given to the same employee up to **\$400.00** in any year. If the employee achievement awards are given under an employer’s *qualified plan* (*i.e.*, a written plan or program approved by the IRS and which does not discriminate in favor of highly compensated employees), the \$400 deduction limitation is increased to **\$1,600.00** per employee. The *average cost per employee* of all employee achievement awards given pursuant to all of the employer’s established written plans during any given year *cannot exceed* **\$400.00**, however. Although the employer may deduct the cost of employee achievement awards, they *are not taxable* to the employee.

If an award is one of “*nominal value*,” its cost is excluded from the calculation of the total amount of incentive awards given under established *written plans or programs* in any year. The IRS has not said what constitutes nominal value for these purposes, but most experts believe that up to \$50.00 is of nominal value, while others believe that an award of up to \$100.00 should be treated as one of nominal value.

Tangible personal property excludes certain items. Accordingly, an incentive award cannot be in the form of cash or a gift certificate (other than a non-negotiable certificate conferring only the right to receive tangible personal property). Any certificate that may be converted to cash is not “tangible personal property” and cannot qualify for preferential tax treatment. Other items that are not tangible personal property include travel, vacations, meals, lodging, tickets to theater or sporting events, and stocks, bonds, or other securities. The fair market value of incentive travel awards given to employees *is taxable* as additional income to them and deductible by the employer as compensation paid.

A length of service award can be excluded from an employee’s income only if it is received by the employee after his first five years of service with the employer making the award, and then only if the employee has not received another length of service award from his

employer for at least five years. An award for safety achievement can be excluded from an employee's income only if that employee is a full-time employee (other than a manager, administrator, clerical worker or other professional employee), and then only if during the taxable year all other employee awards for safety achievement have previously been made to 10% or less of the eligible full-time employees of the employer, excluding awards that are not taxable because they are *de minimis* fringe benefits. Once the 10% limitation is exceeded in any given year, the employer may not deduct the cost of any subsequent safety achievement awards.

B. Some Special Situations

The rule that an award for safety achievement can be made to up to 10% of eligible employees only has created a lurking problem for employers and employees under the Fair Labor Standards Act (FLSA), if the employer does not structure its safety incentive program properly. The FLSA and its regulations generally require an employer to include in an employee's regular rate of pay all remuneration except certain specified types of payments. Thus, discretionary bonuses, gifts, payments in the nature of gifts on special occasions, contributions to certain types of welfare plans, and payments to certain types of profit-sharing, thrift, and savings plans are not included in an employee's regular rate of pay. Nondiscretionary bonuses are included in an employee's regular rate of pay. As a result, prizes awarded for perfect attendance, good safety records, excellent service, and the like are generally considered to be additional remuneration for employment and require that their value be rolled back into the employees' regular rate of pay for overtime purposes. For example, if an employee can earn some prize automatically by attending safety meetings, by having a perfect safety record, or getting a certain customer service rating, over a period of time such as one month, the prize would probably be treated as additional remuneration earned by the employee for his employment. Thus, it becomes very important for an incentive firm and employer to structure a safety incentive program so that it fits within the requirements of Internal Revenue Code section 274(j), especially at companies where employees work considerable amounts of overtime. (The FLSA does not create any special problems where employees work little or no overtime.)

As long as the merchandise that the employee receives for safety achievement satisfies specific rules of section 274(j) of the Code, it would not be taxable as compensation for income and payroll (FICA) tax purposes. Similarly, the safety achievement award should not be deemed to be additional remuneration for employment for purposes of the FLSA. The most common pitfalls for safety achievement plans is that awards may sometimes be given to more than 10% of eligible employees, or that the awards are not merchandise or other tangible personal property (for example, travel, vacations, meals, lodging, tickets to theater or sporting events, and the like). Incentive firms should be extremely careful that safety achievement awards qualify for preferential tax treatment under section 274(j) of the Code, or the employer may lose its deduction and be liable for additional overtime to its employees under the FLSA, and the employee may be required to include the award in his or her income.