Primer on the Federal Income Tax Treatment of Incentive Awards

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Editor's Note: This memorandum provides a brief overview of the federal income tax treatment of employee awards. It's good information to have when you are selling employee recognition programs to your clients. January 2000.

Section 274(j) of the Internal Revenue Code, enacted by the Tax Reform Act of 1986, provides, in general, that an employer may deduct the cost of employee achievement awards given to the same employee up to $400.00 in any year. If the incentive awards are employee achievement awards made under one or more established written plans or programs of the employer, the $400 deduction limitation is increased to $1,600.00 per employee.

Under Code section 74(c), however, the same awards are not included in the income of the employee. In addition to being excluded from the employee's taxable income, the employee achievement awards are also excludable for employment tax purposes as well as from the social security benefit base. The employer must report on the employee's form W-2 as wages or compensation any portion of the employee achievement awards that is included in the employee's income. This amount is also treated accordingly for all other tax purposes (including social security tax).

In order to qualify for this favorable tax treatment, an incentive award must be an "employee achievement award," that is, it must be an item of "tangible personal property" transferred by an employer to an employee for safety achievement or length of service. Moreover, the award must be given as part of a meaningful presentation and cannot be the payment of disguised compensation to the employee. Thus, 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's used as a substitute for a program of awarding cash bonuses. Code section 274(j)(3)(A).

There is very little guidance issued by the Internal Revenue Service ("IRS") on employee achievement (incentive) awards. In the absence of such authority, taxpayers have had to rely on the General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation (JCS-10-87), commonly referred to as the "Blue Book," and regulations proposed by the IRS on January 9, 1989. These regulations, Prop. Treas. Reg. Section 1.274-8 have not been finalized and are not binding on taxpayers; however, they do provide some insight as to the thinking of the IRS in this area.

The old regulations in effect before the enactment of Code section 274(j), Treas. Reg. Section 1.274-2(d)(1), defined an achievement award as an item of "tangible personal property" given to an employee for length of service, productivity, or safety achievement. New Code section 274(j) does not include awards for productivity in the definition of employee achievement awards. Thus, apparently, an incentive award can be given to employees for safety achievement or length of service only. According to the Blue Book, an award given to an employee for any other purpose, such as exceptional productivity, cannot be excluded from his income. Blue Book at 35, n.14. In view of the change in the law, employers have emphasized incentive awards rewarding length of service and safety achievement and have avoided productivity awards.

The requirement that an employee achievement award must be an item of "tangible personal property" has caused some confusion, because Code section 274(j) does not define the meaning of that term. The proposed regulations do provide some insight into the meaning of "tangible personal property" by defining it to exclude 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 under Code section 274(j). 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. Prop. Treas. Reg. Section 1.274-8(c)(2). As a result, the fair market value of incentive travel awards given to employees is always taxable as additional income to them and deductible by the employer as compensation paid. Many employers, therefore, reimburse employees for the additional tax due as a result of the incentive travel award.

A length of service award can be excluded from an employee's income 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 the employer for at least five years (excluding an award that is not taxable because it is de minimis fringe benefit). Code section 274(j)(4)(B). 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 employee awards for safety employer (excluding awards that are not taxable because they are de minimis fringe benefits). Code section 274(j)(4)(C). Once the 10% limitation is exceeded in any given year, any subsequent awards are not deductible under Code section 274(j).

In general, the employer's maximum deduction for all safety and length of service awards provided to the same employee during the taxable year cannot exceed $400.00, except if the award is made under an established written plan or program. In that case, the maximum deduction is increased to $1,600.00 for the cost of all such awards made to the same employee during the taxable year, whether for length of service or safety achievement. Code section 274(j)(2). The separate $400.00 and $1,600.00 limitations cannot be added together so as to provide a deduction in any year exceeding $1,600 for any one employee. Code section 274(j)(2)(B).

While the maximum deduction is $1,600.00 for any employee if the safety or length of service award is granted under established written plans or programs, the average cost per recipient of all employee achievement awards given pursuant to all of the employer's established written plans during any given year cannot exceed $400.00. Code section 274(j)(3)(B)(ii). For example, let's assume ten employees get awards under one or more established written plans. If one employee receives an award that costs $1,600, five employees each get an award that costs $200.00, and four employees get an award that costs $350.00, all of the employee achievement awards in the aggregate amount of $4,000.00 are deductible. No portion of any of the awards is included in any of the ten employees' income, because the average cost of the awards per recipient is $400.00.

If an award is one of "nominal value," its cost is excluded from the calculation and is the total amount of incentive awards given under established written plans or programs in any year. It is unclear what constitutes nominal value for these purposes. Prop. Treas. Reg. Section 274-8(c)(5)(ii) provides that $50.00 is nominal value, but some aggressive employers take the position that an award of up to $100.00 should be treated as one of nominal value. The IRS has not resolved this matter. Thus, until the IRS adopts final regulations, it should be possible to treat employee achievement awards with a value of no more than $100.00, which are given under established written plans or programs, as having nominal value and to exclude them from the total of award costs under such plans or programs in computing average cost per recipient.

The amount of the award that the employee can exclude from his or her income depends on the employer's adherence to the deduction limitations of Code section 274(j). In other words, if the employer can deduct the full cost of the award, the employee can exclude the full cost of the award for his or her gross income. For example, let's assume an employer awards an employee a crystal bowl as a length of service award (but not under an established written plan or program) and complies with the other relevant criteria for incentive awards. The bowl costs the employer $400.00 and has a retail value of $500.00. Because the bowl did not cost the employer more than $400.00, its full retail value of $500.00 is excludable from the employee's gross income. Blue Book, at 36.

If the employer exceeds the cost limitations for the award and loses a portion of the deduction, the employee's exclusion from income is only preserved in part. In this case, the employee must include in
his gross income the greater of (1) an amount equal to the portion of the cost to the employer of the award that was not allowable as a deduction to the employer (not in excess of the fair market value of the award) or (2) the amount by which the fair market value of the award exceeds the maximum dollar amount allowable as a deduction to the employer. Code section 72(c)(2). The remaining portion of the fair market value of the award is not included in the employer's gross income. Blue Book, at 36. For example, let's assume that the crystal bowl described in the last example cost the employer $500.00, rather than $400.00, and its fair market value is $475.00. In this case, the employer's deduction is limited to $40.00 and the amount includible by the employee in his income is $100.00, the greater of (1) the difference between the item's fair market value exceeds the deduction limitation ($100.00) or (2) the amount by which the item's fair market value exceeds the deduction limitation ($75.00). If the fair market value had been $600.00, the amount includible in the employee's income would have been $200.00. Blue Book, at 37.

The fact that IRS has not issued any guidance and has not finalized the proposed regulations under Code section 274(j) leaves several unanswered questions regarding employee incentive awards. My conversations with the IRS and Treasury indicate that they consider final regulations in this area to be a low priority item in the current legislative climate. One unfortunate aspect of this lack of action is that travel awards must be treated as nonqualified, taxable cash awards. (This is consistent with the proposed regulations that are still in effect.)

On the other hand, the inaction of the IRS creates tax planning opportunities (as well as risks) for imaginative companies. Since the IRS remains hostile toward the use of employee achievement awards, however, its inaction probably benefits the incentive industry.