

**Overview of the Federal Income
Tax Treatment of Incentive Awards**

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Since Congress changed the law governing incentive awards in 1986, there has been some confusion about how employers and employees should treat awards for income tax purposes and what types of awards qualify for preferential tax treatment. Section 274(j) of the Internal Revenue Code added 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 pursuant to one or more established *written plans or programs* of the employer, the \$400 deduction limitation is increased to **\$1,600.00** per employee. The advantage of having the incentive award qualify as an “employee achievement award” is that, although it is deductible to the employer, it would *not be included* in the income of the employee. In addition to being excluded from the employee’s taxable income, employee achievement awards also are 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 an employee achievement award that is included in the employee’s income. This amount is also treated accordingly as compensation for all other tax purposes (including social security tax). Note, however, that the employer is not allowed to deduct any portion of the cost of an employee achievement award in excess of the statutory deduction limitations (in effect, the portion that is included in the employee’s income).

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 for *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 is used as a substitute for a program of awarding cash bonuses.

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 (commonly referred to as the “*Blue Book*”), and regulations proposed by the IRS on January 9, 1989, Prop. Treas. Reg. § 1.274-8. The proposed

regulations 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 Tax Reform Act of 1986 defined an achievement award as an item of “tangible personal property” given to an employee for length of service, productivity, or safety achievement. The 1986 Act **does not** include awards for productivity in the definition of employee achievement awards. Thus, 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. In view of the change in the law, employers have emphasized incentive awards rewarding safety achievement and, on occasion, length of service. They have avoided productivity awards.

The requirement that an employee achievement award must be an item of “tangible personal property” has caused some confusion, because the new law did 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. 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. 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 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 (excluding an award that is not taxable because it is *de minimis* fringe benefit). 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 fewer 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.

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. 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.

While the maximum deduction is \$1,600.00 for any one 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. For example, assume ten employees get awards under one or more established written plans. If one employee receives an award that costs \$1,600.00, 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 of the total amount of employee achievement awards given under established *written plans or programs* in any year. It is unclear what constitutes nominal value for these purposes. The proposed regulations provide that \$50.00 is nominal value, but an aggressive employer may take the position that an award of up to \$100.00 should be treated as one of nominal value. This matter has not been resolved by the IRS. 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 an employee can exclude from his or her income depends on the employer's adherence to the deduction limitations of Code § 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 from 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.

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. The remaining portion of the fair market value of the award is not included in the employee's gross income. For example, 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 \$400.00 and the amount includible by the employee in his income is \$100.00,

the greater of (1) the difference between the item's cost and the deduction limitation (\$500.00 less \$400.00 = \$100.00) or (2) the amount by which the item's fair market value exceeds the deduction limitation (\$475.00 less \$400.00 = \$75.00). If the fair market value had been \$600.00, the amount includible in the employee's income would have been \$200.00.

The fact that the IRS has not issued any guidance and has not finalized the proposed regulations under Code § 274(j) leaves several unanswered questions regarding employee incentive awards. It seems that the IRS and Treasury consider final regulations in this area to be a low priority item. 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 might also create tax planning opportunities (as well as risks) for imaginative companies. Accordingly, imaginative employers can be creative in structuring their use of employee achievement awards to motivate their employees.

Unfortunately, the statutory requirements imposed by Code § 274(j) can also create traps for the unwary sometimes. For example, 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 consider prizes awarded for perfect attendance or safety records as additional remuneration for employment and require that their value be rolled back into the employees' regular rate of pay for overtime purposes. Thus, if an employee can earn some prize automatically by attending safety meetings or by having a perfect safety record over a period of time such as one month, the prizes would probably be treated as additional remuneration earned by the employee for his employment. This additional remuneration that an employee will be deemed to have received may require the company to pay him or her additional overtime. One exception to this rule is if the granting of the prize or award is pursuant to a drawing (a lottery or game of chance) where an employee's chances of winning the prize are small. The exception would not apply to most safety incentive programs, however, as they are structured to include a substantial number of employees (up to 10% of eligible employees).

Therefore, it is very important for an incentive firm and employer to structure a safety incentive program so that it fits within the requirements of Code § 274(j). As long as the merchandise that the employee receives for safety achievement satisfies specific rules of that provision, it would not be taxable as compensation for income and payroll (FICA) tax purposes, and it 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. Incentive firms should make sure 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.