Primer on the Federal Income Tax
Treatment of Incentive Awards

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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 in any year. If the incentive awards are employee achievement awards made under an employer's qualified plan (*i.e.*, a **written** plan or program that does not discriminate in favor of highly compensated employees as to eligibility or benefits), the $400 deduction limitation is increased to $1,600 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 (FICA) 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 it is required to include in the employee's income. This amount is also treated accordingly for all other tax purposes (including FICA tax).

In order to qualify for this favorable tax treatment, an incentive award must be an "employee achievement award," *i.e.*, 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 the employer makes annual salary adjustments, 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 that the Internal Revenue Service (the "Service") has issued 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 Treasury regulations proposed 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 Service 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. As a result, 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 deemphasized productivity awards.

The requirement that an employee achievement award must be in the form of **tangible personal property** has caused some confusion, because Code section 274(j) does not define the meaning of that term. The old proposed regulations did attempt to provide some insight into the meaning of "tangible personal property," however, by defining it to exclude certain items. Under the proposed regulations, an incentive award could not 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). Accordingly, certificate that may be converted to cash is not "tangible personal property" and could not 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).

Twenty-one years later, the Tax Cuts and Jobs Act of 2017 provided some additional clarity into the meaning of "tangible personal property" by defining it to exclude certain items. Therefore, the Code now specifically provides that an employee achievement award ***cannot*** be in the form of cash, cash equivalents, gift cards, gift coupons, or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property **from a limited array of such items pre-selected or pre-approved** by the employer). In addition, other items that are not tangible personal property include vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items, presumably including travel. Section 274(j)(3)(A)(ii). As a result, the fair market value of incentive travel awards and other items that are not tangible personal property given to employees is ***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. The definition of "tangible personal property" to exclude specifically certain items went into effect in 2018. The Conference Committee Report to the Tax Cuts and Jobs Act of 2017 states that Congress did not intend any inference that the new definition was a change from pre-existing law.

A length of service award may 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), and they are taxable as income to the employee. Because the award would be taxable to the employee as additional compensation, however, the employer may deduct it as an ordinary and necessary business expense (compensation paid) under Code section 162(a)(1).

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, except if the award is made under an employer's qualified written plan. In that case, the maximum deduction is increased to $1,600 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 and $1,600 limitations cannot be added together to provide a deduction in any year exceeding $1,600 for any one employee. Code section 274(j)(2)(B). Although the maximum deduction is $1,600 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. Code section 274(j)(3)(B)(ii).

The interplay of the dollar limitations can be shown by the following or example. 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, and four employees get an award that costs $350, all of the employee achievement awards in the aggregate amount of $4,000 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.

If an employee achievement 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. Code section 274(j)(3)(B)(ii). It is unclear what constitutes nominal value for these purposes. Prop. Treas. Reg. Section 274-8(c)(5)(ii) provides that $50 is nominal value. Because those old proposed regulations were from 1989, however, some tax practitioners might argue that an award of up to $100 should be treated as one of nominal value to allow for inflation. Thus, until the Service adopts final regulations, an employer may have to treat employee achievement awards with a value of up to $100 (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. For now, the amount that constitutes "nominal value" remains undefined.

The amount of the award that the employee may 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, 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 and has a retail value of $500.

Because the bowl did not cost the employer more than $400, its full retail value of $500 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 under Code section 274(j), the employee's exclusion from income is only preserved in part.[1] 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 74(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, assume that the crystal bowl described in the last example cost the employer $500, instead of $400, and its fair market value is $475. In this case, the employer's deduction under Code section 274(j) is limited to $400 and the amount includible by the employee in his income is $100, the greater of (1) the difference between the item's cost that exceeds the deduction limitation ($100) or (2) the amount by which the item's fair market value exceeds the deduction limitation ($75). If the fair market value had been $600, the amount includible in the employee's income would have been $200. Blue Book, at 37.

The fact that Service 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 most recent conversations with Service and Treasury staff indicate that they consider final regulations in this area to be a very low priority item. One unfortunate aspect of this lack of action is that travel awards must be treated as nonqualified, taxable cash awards. On the other hand, the inaction of the Service may create tax planning opportunities (as well as risks) for imaginative companies. Because the Service remains hostile toward the use of employee achievement awards, however, its inaction probably benefits the incentive marketplace.

[1] It is worth remembering that although the employer would lose part of its deduction under Code section 274(j), the employer may deduct the taxable portion of the award to the employee as compensation paid to him or her under Code section 162(a)(1).