TAX ISSUES FOR AWARDS

Introduction

> An award is something bestowed or an action taken to recognize and reward individual or team achievement, including incentives based on predetermined criteria.

This paper addresses the impact of the various tax laws on the Government's awards program and focuses on awards given under the Governmentwide authority found in chapter 45 of title 5, U. S. Code. You will find the regulations on awards discussed here in part 451 of title 5, Code of Federal Regulations. These regulations include a specific provision that requires agency awards programs to ensure they do not conflict with or violate any other law or Governmentwide regulation (5 CFR 451.106(a)). This requirement includes compliance with applicable tax rules such as withholding. Changes in the tax laws over time have clarified the concept of what is taxable, which has been particularly important because employers now compensate employees in more ways than traditional pay and benefits. These forms of additional compensation often are called "fringes" or "perks."

Agency Tax Obligations

Federal agencies are employers of their common law employees for employment tax purposes. Cash you provide to your employees as compensation (i.e., salary, wages, and supplemental wages) is generally taxable. Taxable fringe benefits are those items (often noncash) you provide to your employees that the Internal Revenue Service (IRS) views as supplemental wages (i.e., additional compensation). Some taxable fringe benefits, which are usually seen in the private sector rather than the Federal Government, might include membership in a private country club or athletic facility, or season tickets to sporting or theatrical events. Fringe benefits are taxable unless they meet specific exclusion criteria. <u>See</u> Publication 15-B, Employer's Tax Guide to Fringe Benefits, for detailed information on the employment tax treatment of fringe benefits.

Generally, tax liability carries a dual responsibility—

1. Employees must pay taxes on compensation received.
2. You must withhold taxes for compensation "paid," plus pay your share of the Federal Insurance Contributions Act (FICA) taxes.

You must report as compensation (i.e., W-2 wages) and withhold taxes for—

1. most cash payments;
2. the fair market value of award items determined to be non-exempt, taxable fringe benefits; (See later section on *Determining Fair Market Value.*) and
3. award items considered to be cash equivalents. (See later section on *Cash Equivalents.*)

As an employer, you have an obligation to comply with the IRS rules and regulations and withhold applicable taxes from an employee's wages. You are familiar with this withholding obligation regarding employee salaries and other cash payments, which has been in effect for a long time. See Publication 15 (Circular E), Employer's Tax Guide, for detailed information on an employer's responsibilities for withholding, depositing, and reporting employment taxes. However, it is only since January 1985 that the IRS clarified its application to the newer noncash "fringe benefits."

For example, employee parking on Federal property is a fringe benefit, and you must withhold taxes for the parking's fair market value to the extent it exceeds the value excluded by the Internal Revenue Code. Generally, only in large, metropolitan areas would the fair market value of such parking have to be reported as a fringe benefit because it exceeds the amount allowed to be excluded.

Carrying out your tax reporting and withholding responsibility involves policy choices that you should develop in cooperation with your payroll officials and incorporate into your award program design and administration. You should consider carefully the tax implications of using a particular type of award so that you can properly carry out your responsibility to withhold required taxes. However, after you have reviewed your various awards and considered the impact of the IRS regulations, the practical effect may be that many, if not most, noncash awards you use are not, in fact, taxable. The information in this paper describes things to consider when using your judgment to make these decisions, as well as some of the limits you will have to consider.

> You are responsible for reporting the different kinds of compensation you give your employees and withholding the right amount.

The Increasing Use of Noncash Awards

In this era of reinvention, deregulation, and tight budgets, you are looking for new and innovative ways to reward your employees and stretch your awards budget. To find new ideas, many of you are benchmarking best practices, often in private industry as well as not-for-profit organizations. What you are finding is that industry often uses, and highly recommends the effectiveness of, gift certificates or other cash equivalents, merchandise, and other noncash items used as incentives and recognition. As a result, you are looking at the applicability and consequences of these types of awards in the Federal environment. In addition to their overall appropriateness, another issue you need to consider is the tax implication of such awards. Generally, the Government has limited its noncash award programs to honorary recognition using items such as plaques, certificates, and medals. These items clearly convey honorary recognition and do not run the risk of being mistaken for hidden or additional compensation, which could make them taxable as fringe benefits. As you use more informal recognition and the noncash forms taken by both honorary and informal recognition broaden, you must pay more attention to whether these awards could be considered to represent additional compensation and what tax implications that brings.

> Traditional certificates, plaques, medals, and pins usually are not taxable.

Taxing Cash and Cash Equivalents

Cash and cash equivalents are generally taxable, regardless of the amount.

Cash and cash equivalents given as awards are generally taxable, regardless of the amount. Checks are the most common form of a cash equivalent. Gift certificates and vouchers with a clear face amount are also cash equivalents. Under certain situations and circumstances, items that might otherwise be exempt from taxation become taxable as cash equivalents. (See section on *The Effect of Employee Choice.)*

Using Gift Certificates As Awards

From a tax perspective, gift certificates (e.g., a $10 certificate to a specific restaurant or store) are a cash-equivalent fringe benefit. Like other cash fringe benefits, they generally are taxable regardless of their amount. Because of the expressed monetary value, gift certificates are cash equivalents even though the recipient generally cannot convert them to cash. Also with some gift certificates, the recipient may lose the amount of any difference in value between a lower priced item and the certificate's face value, although this is less true of the debit card type of gift certificates often used today. As with a cash award of any amount, you must report any noncash award that is a cash equivalent as wages. You withhold applicable taxes based on the face value of the gift certificate. (See later section on *Withholding Income Tax and "Grossing Up."*)

Single-item vouchers and gift certificates are not the same.

Some employers in the private sector have a long tradition of giving their employees a holiday "gift." These "gifts" often take the form of food, such as a turkey or ham. Sometimes employers use redemption coupons instead of having the specific item on hand. An example would be the use of a redemption coupon from a specific store for the traditional holiday turkey. In this case, the coupon is merely a convenient substitute for the item itself and cannot be redeemed anywhere other than where specified for anything other than the specified item. Therefore, such coupons are not cash equivalents because of the very limited way in which they must be redeemed. In this example, since the item the coupon will redeem is of *de minimis* value, you do not need to withhold tax or report it as a taxable fringe benefit assuming you provide the benefit infrequently, e.g., once a year. (See later section on *"De Minimis" Value of a Noncash Award*.)

You must not confuse a cash equivalent with a cash surrogate. Cash surrogates are cash awards you give in forms like a traveler's check or a cash debit card. OPM has guidance available that discusses this category of cash awards. (https://www.opm.gov/perform/articles/1999/cshsurgd.asp) Since these "cash surrogates" are a form of cash award, like other cash awards they are taxable and you report them to the IRS as wages. You make the determination whether you have to treat a noncash award as a cash equivalent for tax purposes. (See section on *Taxing Noncash Awards.*)

U.S. Savings Bonds—A Special Case

OPM considers a Series EE Savings Bond to be a noncash award item because it is a Federal contract that someone purchases or receives and must hold for six months before he or she can cash it. A Savings Bond is a cash equivalent because it has a clear face value like a gift certificate and, therefore, it is taxable. However, the face value of the Bond is not its actual value until it reaches maturity. So, when you give a Bond to an employee as either an honorary or informal recognition award, you must report it to the IRS as supplemental wages or a taxable fringe benefit. However, when you do, you report the fair market value of the Savings Bond instead of its face value. The fair market value of the Bond is its value at the time you give it to the employee, which is usually the cost of the Bond. (Information on reporting supplemental wages and taxable fringe benefits is available in *IRS Publication 15 (Circular E), Employer's Tax Guide*.)

> Taxes are withheld on the fair market value of a Savings Bond, which is usually its cost.

The fair market value of the Bond, rather than its face value, is also the amount on which you base tax withholding. It is the employee's responsibility to report as income and pay taxes on the interest earned on the Savings Bond between the time the employee receives it and later cashes it. Payroll Offices generally are familiar with these various reporting requirements. If they have additional questions, your payroll officers can contact the IRS for further information on reporting and withholding taxes on U.S. Savings Bonds.

Taxing Noncash Awards

For tax withholding purposes, a noncash award (i.e., honorary award or informal recognition award) is a fringe benefit. Cash, including cash surrogates, and cash equivalents (e.g., a gift certificate, voucher, or charge or credit card) must have appropriate taxes withheld regardless of their amount. Fringe benefits, on the other hand, can sometimes be tax exempt. There are two conditions under which you do not include the value of a noncash award in the employee's wages and report it to the IRS—

> Some noncash awards may be exempt from the reporting requirements for taxable fringe benefits.

1. When it is a *de minimis* fringe benefit, and
2. When it meets the definition of an "employee achievement award" and does not exceed certain limits (see section on *Tax Exclusions for "Employee Achievement Awards"*).

When noncash awards do not meet these conditions, then you must report their fair market value to the IRS and withhold the appropriate taxes. In addition, another decision you must make is whether you will "gross up" the amount you report as wages to include an additional amount to cover the taxes. (See section on *Withholding Income Tax and "Grossing Up."*) If you choose not to "gross up" a noncash award, the employee is still responsible for the taxes. Usually, withholding those taxes reduces the employee's net income for the pay period when you report the award to the IRS.

Agency Decisions

When giving noncash awards, you will need to make three separate determinations, and they all contain elements of judgment—

1. Whether a noncash award is a *de minimis* fringe benefit,
2. Whether a noncash award is an “employee achievement award,” or
3. Whether you will “gross up” to cover the taxes due.

The following paragraphs provide details on each of these issues to assist you in making these determinations. Ultimately, you should do a case-by-case analysis to determine the taxability of each noncash award. You should develop your own policies regarding whether and when “grossing up” is appropriate.

De Minimis Value of Noncash Awards

For noncash awards, the exclusion for a *de minimis* fringe benefit is the principle tax exemption applicable to the Federal Government. The IRS has no specific dollar value associated with *de minimis* but it generally means property or services of negligible value. However, even items of little individual value do not qualify as *de minimis* when you give them frequently to the same person. Sometimes IRS publications use the terms *de minimis* and “nominal” interchangeably. However, under OPM and IRS guidance these terms have different meanings and represent different determinations you need to make. The IRS states that you should not use a relativity test when determining whether an item’s value is *de minimis*. In other words, you make the determination based solely on the fair market value of the item you give. You do not make a relative comparison of the item’s value to the employee’s income or the locality where you bought the item.

> The Internal Revenue Code defines a *de minimis* fringe benefit as any property or service the value of which is (after taking into account the frequency with which the employer provides similar fringes to his/her employees) so small as to make accounting for it unreasonable.

Depending on the particular circumstances, you might consider either honorary awards or informal recognition awards to be *de minimis*. You make the determination based on the fair market value of the item you give.

Determining Fair Market Value

Treasury regulation (§ 1.61-21(b)(1)) provides guidance on how to determine the fair market value of a fringe benefit—

> “In general, fair market value is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an

arm's-length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit's fair market value nor is the cost incurred by the employer determinative of its fair market value."

You must decide whether informal recognition awards have a *de minimis* fair market value. An example might be ballpoint pens or mugs with a team motto that you give to every member of a project team for completing its assignment ahead of schedule and under cost. The fair market value of the item each individual gets is very small, and it is administratively inefficient to report it as part of the employee's wages. Another example could be a food item (e.g., pizza, donuts, a box of candy) or flowers you give to an employee in recognition of some achievement. It is important to note the examples provided in materials published by the IRS generally do not reference a connection to the employee's contribution. Their guidance refers to fringe benefits in general, employer gifts, and to situations beyond the granting of awards, which is our focus here.

You should direct any questions you have regarding the appropriate application of the IRS guidance to your local IRS office, or to the Office of the Associate Chief Counsel (Tax Exempt and Government Entities) in Washington, DC. The attorneys there can help you understand how to take into account all the facts and circumstances surrounding an award to determine whether the award item qualifies as a *de minimis* fringe benefit. Such a review might determine, for example, that presenting a departing employee who rendered judicial-type decisions or opinions with a leather-bound set of his/her decisions (i.e., an honorary award) qualifies as a *de minimis* fringe benefit. Various types of honorary awards traditionally used in the Federal Government (e.g., plaques and citations) tend to be tax exempt on this basis. Again, if you have any question whether a specific award item would qualify as a *de minimis* fringe, you should contact the IRS to discuss the specific situation.

> Get More Help — Direct specific questions on meeting the conditions for award reporting exclusions to your local IRS office or the Office of the Associate Chief Counsel (Tax Exempt and Government Entities), IRS, Washington, DC, at (202) 622-6040.

The Effect of Employee Choice

Whenever you give an employee a considerable choice in selecting the item received as a noncash award, the award rarely meets the conditions for *de minimis*, regardless of its fair market value. It does not matter whether it is honorary or informal recognition. For tax purposes, giving an employee significant choice is equivalent to giving them a cash-equivalent gift certificate. However, you still base the cash equivalence of these items on their fair market value, not your cost. Consequently, for tax purposes, catalog programs that give employees a wide degree of choice within specified limits, such as color-coded categories where all the items are of about the same value, are equivalent to giving a gift certificate. These programs often work in the same way as some merchant gift certificates where

> Giving employees a choice among several items is the same as giving them a gift certificate.

the employee cannot get back any excess amount of award credit if he or she chooses an item from a lower value category. Nevertheless, you would base any tax liability associated with such an award on the value of the category from which the employee was eligible to choose, whether or not he/she actually chose something from the higher-value category. (See related section on *The Principle of Constructive Receipt.*) The item's fair market value (or, if higher, the value of the category from which the employee was eligible to choose), not your cost, is the amount you report to the IRS as a taxable fringe benefit and on which you withhold taxes. (See related section on *Withholding Income Tax and "Grossing Up."*)

Therefore, the element of choice plays a significant role in determining whether you can consider a noncash award to be a *de minimis* fringe benefit, and thus exempt from taxation. If the employee has significant choice in what he or she actually receives as an award (e.g., gift certificate or catalog category), you treat the award as a cash equivalent for tax purposes. The award's face value if it is a gift certificate, or its fair market value if it is a catalog item, is taxable and you report it as wages.

The Principle of Constructive Receipt

Another aspect of employee choice is its relationship to the doctrine of constructive receipt. Under the doctrine of constructive receipt, if a taxpayer is offered income, but chooses not to take it, he or she is generally still taxable on that income.

Section 1.451-2(a) of the Income Tax Regulations defines the doctrine and states— "Income, although not actually reduced to a taxpayer's possession, is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given." In other words, if you offer a taxpayer (e.g., an employee) income (regardless of whether he or she actually takes it), it generally is taxable income.

> Giving the employee the choice between different types of awards could have significant tax consequences.

Accordingly, if an agency as the employer offers an employee a choice between two types of awards (e.g., such as cash and a time off award, or cash and a quality step increase) and the employee chooses the item of lesser value, the employee is in actual receipt of the item of lesser value and is also in constructive receipt of an additional amount equal to the difference in value between the two items. As employers, agencies should consider the complex tax implications under the doctrine of constructive receipt when deciding whether to offer employees the choice between two items of value.

Tax Exclusions for "Employee Achievement Awards"

> "Employee Achievement Awards" have a unique meaning for the IRS.

Meeting the requirements for "employee achievement awards" is the second way an award might be tax exempt. These "employee achievement awards" are not cash awards and, generally, the Federal Government does not use them. These awards are more typical in the private sector and, based on the many restrictions involved, probably would not have much applicability in most Government agencies. The Internal Revenue Code (§ 274 (j)(3)) very specifically defines an "employee achievement award" as tangible personal property given as part of a meaningful presentation, and not as disguised compensation, in recognition of length of service or safety.

Length of Service Awards

You probably recognize an employee's length of Government service by presenting them with a certificate and possibly a pin, which is the typical way the Federal Government recognizes length of service. This type of informal recognition would generally meet the requirements for exemption as an "employee achievement award." However, because the basis for the exemption for "employee achievement awards" is the amount private sector employers may deduct as a business expense, it is very complicated to understand. Since traditional Government recognition for length of service generally meets the exemption criteria for *de minimis* fair market value, it is probably easier to use that exemption when you determine whether it is necessary to report such recognition as additional employee income or a taxable fringe benefit.

Limitations for Safety Achievement Awards

You need to apply very specific requirements and limitations when you decide whether these awards qualify for tax exemption. The Internal Revenue Code (§ 274(j)(4)(C)(ii)) specifically does not permit the exclusion of awards you give as safety achievement awards when you give them to a manager, administrator, clerical employee, or other professional employee. This restriction greatly limits employee eligibility. The Federal Government probably has very few, if any, programs that give tangible personal property as noncash awards in recognition of safety achievement to employees who the Internal Revenue Code does not list above as ineligible. Our award programs usually use noncash awards (i.e., tangible personal property) to recognize individual or group special achievements (i.e., special act or service awards). Awards you give for special achievements would not be eligible for exclusion under this provision. If you believe you grant qualifying "employee achievement awards," you should contact the IRS for additional guidance on applying the appropriate taxation and exemption rules.

Withholding Income Tax and Grossing Up

A noncash award item is taxable when it cannot meet the criteria for a *de minimis* fringe benefit or an "employee achievement award." You must report the fair market value (see previous section on *Determining Fair Market Value*.) of the item as wages and withhold the applicable taxes.

It is your choice whether to "gross up" the employee's wages in order to cover the employee's taxes due (i.e., income taxes and the employee's share of FICA taxes) on a noncash award. You pay your share of FICA taxes regardless of whether you "gross up" the employee's wages. (See *Revenue Rule 86-14* for additional information.) When you "gross up" wages to cover the taxes of a noncash award, you must include both the value of the award (face value for a cash equivalent and fair market value for an item) and the “grossed up” tax amount in the employee’s wages. When you increase the amount you report as gross wages to include the amount needed to cover the taxes due, this continues to increase the base upon which the employee must pay taxes. The repetitive calculations that result are known as “pyramiding.” If you want to “gross up” to cover the taxes due, the IRS provides a formula for calculating FICA taxes that addresses the issue of “pyramiding.” (See *Revenue Procedures 81-48* or contact the IRS.) However, no similar formula exists for income tax calculations.

Generally, you should not “gross up” cash awards. When you do, you may actually be over-rewarding the employee achievement being recognized. Instead, you include the entire amount of the cash award in the employee’s wages, and you withhold the taxes from the gross award amount, leaving the money the employee actually receives. However, when you give a recognition item and do not “gross up” wages to cover the taxes, you only include the fair market value of the item in the employee’s wages. You still must withhold the applicable taxes and pay them to the Treasury. This results in a lower net amount in the employee’s paycheck.

> A noncash award item can “cost” the employee money.

The literature in this area tends to recommend “grossing up” noncash award items so you do not diminish their value to the employee. Some companies in private industry tend to “gross up” wages when a noncash award is of significant value, but policies vary from company to company. You should develop your own policy on whether and when to “gross up” taxable noncash awards. You need to decide whether to “gross up” at all, and if you decide to do it, whether to “gross up” all awards or only certain ones. For example, you might designate a specific dollar value above which you would “gross up” a noncash award. For awards with a fair market or face value above that amount, you would report both the value of the award and the amount needed to cover the taxes due in the employee’s wages. You always base the amount you report for a noncash award item on its fair market value, unless it is a cash equivalent when you report its face value. Another approach you could choose would be to “gross up” all noncash awards regardless of their value. This approach avoids creating a net loss, however small, to the employee’s salary. If you decide to “gross up” certain noncash awards and incur the associated costs for the agency, the awards statute authorizes spending the money to cover the taxes as part of the expenses incurred for the honorary recognition of the employee. Remember, you use a different set of criteria to decide whether or when to “gross up” an award than you use when deciding whether the award itself is taxable.

> The practice of “Grossing up” awards costs the agency money, so make sure it is included in your budget.

Summary — Reporting Decision Tree

As you have seen in the information presented here, sometimes the tax laws exempt certain noncash award items from supplemental wage and taxable fringe benefit reporting and tax withholding requirements. The following is a step-by-step questioning route to help you determine whether an award item might meet one of those exemptions. This questioning route applies only to noncash award items, not cash awards. You always report cash awards and withhold appropriate taxes.

1. Is the award a cash equivalent (i.e., does it have a clear, monetary face value or does it give the employee broad choice in selecting the final item received)?

   If yes; then you have to report it and withhold taxes.

   If no; then the award may be exempt.

2. Is the fair market value of the item *de minimis* (i.e., so small that accounting for it is unreasonable or administratively impracticable) after taking into account all the facts and circumstances, including frequency?

   If yes; then it is a tax exempt fringe benefit.

   If no; then you will probably have to report it and withhold taxes (see #3).

3. Is the award tangible personal property given as an "employee achievement award" for safety or length of service?

   If yes; then the award may be exempt.

   If no; then you will have to report it and withhold taxes.

Since published tax guidance can be difficult to interpret and apply, if you have questions on specific awards you want to give or the tax implications of award programs you want to implement, you can get additional guidance by contacting the local IRS office or the Office of the Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service, Washington, DC, at (202) 622-6040.