

Tax Considerations for Incentive Programs

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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.

I. 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 walkman used as an award in an incentive program is \$100, its fair market value should be approximately \$70.

II. 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.

III. 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.

IV. 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.