Incentive Programs and Taxation

Claryifying the Confusion

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Want Employees to be Happy With Your Incentives? Understand the Tax Code and Communicate

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With due respect to Benjamin Franklin, "death and taxes" are not the only things in this world that are certain. Also certain is that tax considerations stemming from corporate incentive programs will sometimes confuse employers and can discourage the very employees the incentive programs were designed to motivate if not properly addressed. The good news, the tax code actually has provisions that support the qualified use of merchandise awards in employee recognition, achievement, and safety programs.

By understanding the nuances of the code, and educating employees as necessary, employers can ensure that the tax code does not interfere with the positive impact of the program.

Twenty Years of Uncertainty

United States tax laws pertaining to incentive programming changed significantly with the Tax Reform Act of 1986.

That piece of legislation—along with a series of restrictions added later by the Internal Revenue Service—redefined what is or is not deductible (by either employer or employee) and created limitations that require ongoing interpretation by organizations operating incentive programs. Along the way, there has been any number of anecdotal instances in which employee emotions have devolved from "feeling rewarded" to "feeling ripped-off."

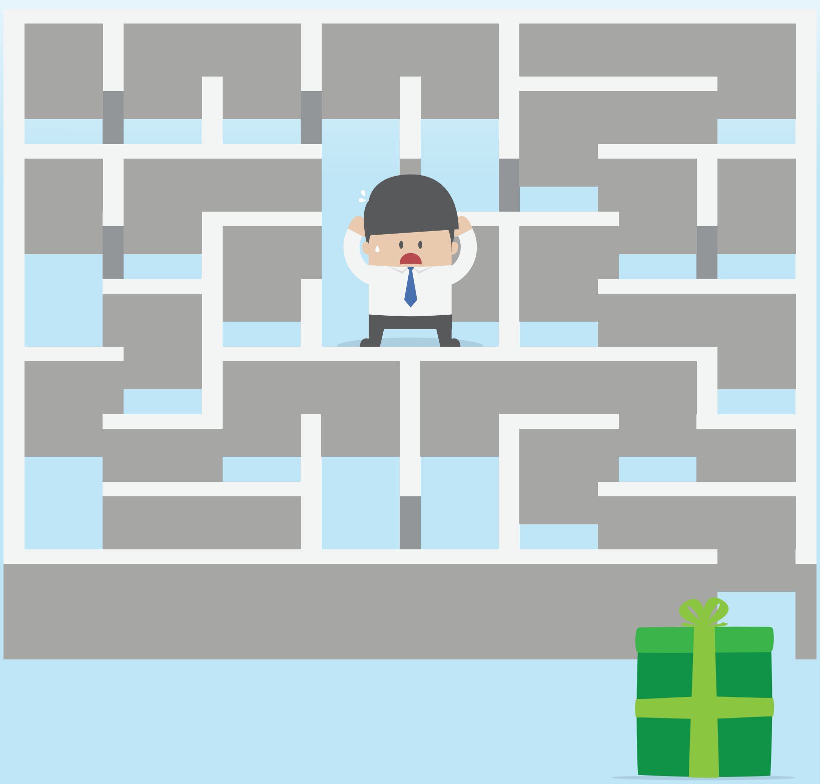
The potential for confusion was evidenced by a proprietary survey MI conducted in 2007.[1] Of the 155 companies that responded, fully half characterized tax laws related to incentive awards as either

somewhat or very difficult for their organizations to understand.

Moreover, nearly all respondents (approximately 90 percent) believed "tax-related employee concerns or complaints lessened employee enthusiasm for the programs." It's worth noting that this feedback was generated from organizations offering a wide array of employee incentive programs, ranging from cash and travel awards to gift cards and merchandise. Even today, it is likely that confusion remains.

What do employees complain about?

The specific nature of employee complaints cited in this survey run a gamut, but the overarching implication is that a lack of expectation or knowledge about the tax ramifications of incentive awards can reduce good will.



A sampling of employee complaints:

- I didn't know (this award) would generate a 1099."
- "(The award) costs money for doing a good job."
- "You give it and then take it away."
- "I'm not getting the full award!"
- "It's a gift; it shouldn't have to be taxed!"

"Taxation was not clearly communicated at the beginning of the program."

The above remark is worth emphasizing, and reinforces the importance of strategic communications in order to promote a harmonious, well-educated workforce.

Clearly, employees annoyed by the infringement of taxes on their earned reward often adopt a "shoot the messenger" mentality. The question then becomes: What can employers do to help diffuse this situation? As referenced in the introduction, employers can more effectively structure their programs through a stronger understanding of the prevailing tax code—and they can prepare employees (emotionally and intellectually) for often the same taxes they would have to pay for any type of compensation.

Nuances of the Tax Code

The tax law governing incentive programming[2] clearly states,"bonuses or awards you receive for outstanding work are included in your gross income and should be shown on your Form W-2. These include prizes such as vacation trips for meeting sales goals." It further notes, "If the prize or award you receive is for goods or services, you must include the fair market value of the goods or services in your income."

Yet—and this is a critical point to understand—certain categories of programs defined as "employee achievement awards" are subject to favorable treatment, especially for programs using merchandise rewards. Traditional award programs for salespeople and employees require employers to report the award in an employee's W-2 Form. For independent contractors and agents, there is no need to send a 1099 unless the value of the award is $600 or more.

For programs complying with specific provisions included in the 1986 Tax

Reform Act, employees who earn "tangible personal property" (other than cash, gift certificates or the equivalent) as an award for length of service or as a safety-related achievement can actually deduct the value from income—up to $1,600 (or $400 for if the award isn't spelled out in the company's established written plans and programs). These awards must be granted as a part of a "meaningful presentation" and be part of formal programs to promote productivity and safety to pass the test of not, in actuality, being disguised compensation. Of double benefit, companies can deduct the cost as well.

To qualify, these awards have to be part of qualified, documented length of service achievement or safety awards. George Delta, an attorney who frequently consults on tax matters, writes, "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."[3]

Certainly, much of these definitions and requirements are subject to considerable interpretation. "Tangible personal property" is not defined specifically by the tax code, although the stated exclusion of cash and gift certificates provides a degree of guidance. The sort of branded and non-branded merchandise mostly used in these programs does qualify under the provisions.

Shifting gears for a moment, let's examine the benefit from the employer's perspective.

According to Delta, the employer's maximum deduction for employee achievement awards cannot exceed $400 unless the award is made under an established program. This relates to average-cost-per-recipient, as long as the value given to any single employee does not exceed $1,600. To illustrate using one of Delta's examples: Assume that 20 employees earn awards under written plans. Two employees earn $1,600 awards, 10 earn $200 awards and eight earn $350 awards. In this scenario, all awards are deductible because the aggregate amount of $8,000, divided by 20 employees, is still only $400.

Taxes and Incentive Travel

The Tax Reform Act of 1986 also influences how companies treat incentive travel.

The rules here can be frustratingly vague. But put succinctly, with the assistance of James Gossett, an attorney for the Society of Incentive Travel Executives,4 employers can generally deduct travel related to company meetings as long as documented proof of the business meeting exists. As far as incentive travel, it depends on whether or not the program was "ordinary and necessary."

Gossett writes, "Generally, if the award program directly benefits the sponsoring company (by encouraging employees, customers, and suppliers to reach greater levels of performance), and the awards themselves are not outrageously lavish, the award program will pass the 'smell' test and be deemed an 'ordinary and necessary' business expense."

What constitutes "lavish"? Gossett offers an example of providing a customer with a $5,000 cruise for the purchase of $200 worth of goods.

Many companies use national sales meetings or new product introductions as a means of motivating, and they do not have to issue 1099s to employees if the primary purpose of that meeting is education and training—as long as it is held in the U.S. and neighboring countries with tax agreements with the United States.

The clear implication here is that the tax code pertaining to incentive programming of all types is defined… to a degree. Your best bet is to consult with tax accountants and attorneys to ensure your organization is adhering to the letter and spirit of the law.

The code and independent contractors

The use of independent contractors is increasing and there are times when companies want to include these individuals in their awards programs as well. Delta advises: "If the recipient is an independent contractor, the award would have to be reported on his or her Form 1099 if it is at least $600. The award would be taxable even if its FMV is less than $600, but the Form 1099 reporting obligation kicks in at $600.

What about the employees?

No doubt companies will—and most certainly should—continue to offer incentive awards to high-performing employees in order to reward them for outstanding work, and to continue motivating that same level of outstanding performance. The issue, however, remains that many employees feel "de-motivated" when the tax bill comes, even though they're still ahead of the game.

How can an employer negate, or at least soften, that blow? Employers have several avenues at their disposal, all of which reinforce the importance of strategic communications in order to promote a harmonious, well-educated workforce:

Be Upfront and Provide Context

Quite often, the worst part of being hit with unexpected taxes is the "unexpected" part. By educating employees upfront about the potential tax implication of the award, you are addressing the issue at a time when you can frame the tax within the context of the entire award. For example, "You have earned a high-profile $5,000 award that retains 80 percent of its value even after taxes are taken into consideration."

Engagement and Good Health Linked

Round Up the Reward

No matter what type of special award or recognition offered, some companies anticipate the tax bill for employees and make an extra payment to offset the tax hit. This often small amount of additional cost has significant impact in terms of increasing the perceived value of the award.

Offer Choices

Employees are more likely to continue valuing their award, even after taxes, if it's an award they truly covet. Rather than insist that every earner of a specific award receive a specific product, give them a variety of choices instead that enable them to tailor the award to their personal tastes.

Mark the Achievement

Whenever possible, reward employees for achievements such as significant anniversaries or safety accomplishments. As discussed earlier, certain categories of programs defined as "employee achievement awards" are more likely to be deductible.

Recognize!

Finally, integrate true, public recognition into your award programs. Employees are less likely to harbor ill feelings when they remember the round of applause they received from colleagues when the award was given.

[1] *Survey on Incentive Awards Taxation, conducted for Marketing Innovators, 2007.*

[2] *Extracted from IRS Publication 525, as found at www.ossonline.com/incentive_tax_info.html.*

[3] *George Delta, "A 2001 Tax Primer," Incentive Magazine, November 2000.*

[4] *"Satisfying the IRS: Incentive Travel Tax Laws," No. 4030, www.info-now.com.*