PBPA Podcast Transcript
Episode 35 – Employee Awards & Gifts: Guidance to Avoid a Tax Spoiler
(33:03 minutes)

Sireesha (00:00):

Employees appreciate employer gifts for any reason, whether it's for a holiday or to mark a work anniversary. But this gift is not as exciting if it's taxed. Yes, the IRS says certain types of employee gifts are taxable, so making sure your nonprofit follows the rules can avoid a spoiler for you or your employees later. In this episode of the PBPA podcast, Darrell Smelcer with Hunton Andrews, Kurth will speak with us about tax rules employers should know if they're planning on thanking their employees with a gift recognition award or a celebratory meal.

Sireesha (00:48):

Hello and welcome to the PBPA Podcast. In each episode of the PBPA Podcast, we explore legal questions relevant to Georgia nonprofits. I'm your host Sireesha Ghanta, Counsel and Education Director at the Pro Bono Partnership of Atlanta. PBPA strengthens our community by engaging volunteer attorneys to provide nonprofits with free business legal services. We provide numerous free resources via our website, including articles and webcasts specific to Georgia nonprofits and their business legal concerns. We also provide direct legal services to our clients. For more information on client eligibility requirements, to apply to be a client or to access our vast learning center, visit our website at pbpatl.org. Before we jump into this episode's topic, keep in mind that this podcast is general information, not legal counsel, contact your attorney for guidance on your nonprofits' specific situation.

Sireesha (01:59):

Darrell Smelcer is public finance special counsel at the law firm of Hunton Andrews Kurth in Atlanta. He has also served as a tax law specialist in the IRS Office of Tax Exempt Bonds. Thanks for joining us today, Darrell. And let's begin very generally. Can you provide some background on the taxation of employee gifts?

Darrell (02:22):

Sure, Sireesha. I'd like to do that. I find this topic to be very interesting because like in so many tax areas the rules that govern this area present a balance of interest. In this case, on the one side is the general federal income tax rule that says that all income will be taxed. Of course, there are a lot of exceptions to that general rule. That's how accountants and tax lawyers make a living. But then on the other side, there's a goal that the IRS and the federal government through the tax code also try to put forth, which is to not make the tax system so overwhelming that people can't comply with it. In the case of what we might call gifts to employees or awards, et cetera both the employee and the employer has a stake in the way these things are balanced.

Darrell (03:23):

The employee, of course, is you said wouldn't enjoy the award or gift as much if they have to pay tax on it. And the, from the employer's side they benefit from simplifying their tax reporting obligations and also reducing the amount of taxes they pay when a gift is exempt. So, I wanna give a little bit more background in this. A as you know, I'm sure employers generally must withhold income taxes from employees wages including social security and Medicare tax. And the employers make deposits of these withheld amounts with the US Treasury, but the employer also pays Social Security and Medicare tax.

And this tax rate is applied to all of the compensation of the employees up to a limit that's now over about 140,000 for the social security and Medicare taxes there real, and there isn't a 0% bracket for Medicare or Medicaid taxes like there is for regular income tax.

Darrell (04:28):

So employers pay the also pay what is called the Federal unemployment tax with respect to compensation to their employees. There's a lower cap on that. It's only $7,000. But the amounts of these taxes are based on the compensation the employer pays or is deemed to have paid. The employee payment of the employer tax amounts is due quarterly, along with the payment to the IRS of the amounts withheld from the employee's wages. So for nonprofits though, the rules are a little bit different. Again you know, for background purposes, we know that organizations described in internal Revenue Code Section 501(c)(3) and other nonprofits described in Section 501(c) are exempt from paying income tax on any profits they might achieve in engaging in their mission. Of course, unrelated trader business income is not exempt from tax, but nonprofits employees are not exempt from paying income tax. And nonprofits also must pay the employer portion of the Social Security and Medicare tax, except with respect to employees paid less than a hundred dollars a year, 501(c)(3) organizations are exempt from paying the federal unemployment tax, but other nonprofits must pay that tax unless they pay the employees less than $50 a quarter.

Sireesha (05:57):

Darrell, you mentioned that there's a general policy that income taxes should be paid on all income. Can you go into that a bit more in the context of employer gifts to employees such as holiday gifts, birthday gifts, or recognition gifts?

Darrell (06:13):

Sure. The basic income tax rule is that unless there's a specific exemption, you pay tax on all income In tax economics, income is defined as any accession to wealth that has been realized. An accession to wealth is really anything of value that is greater than any related cost that is incurred in receiving it. Realizing income means you have control over the increase in wealth. For example, you might own a home that has increased in value since you bought it, but you don't have access to that increased wealth until you sell the home. That would be the realization event. And in that case, there's a specific exemption from income tax for up to $250,000 of that income, $500,000 for those who are filing married and jointly. Now, gifts are also exempt from income tax, but there's, there is a separate gift tax that applies to large gifts.

Darrell (07:19):

And unless an exception applies, the federal income tax law doesn't permit you to deduct the, the cost of giving a gift of more than $25, even if that gift is given in the business context. So essentially, while a person receiving a gift doesn't have to pay income tax on the gift, the taxpayer giving the gift can't deduct its cost over $25, even if it would otherwise meet general rules for deducting a business expense. However, in addition to this law related to gifts, the tax law generally presumes that anything given in connection with the employment relationship, ie-employer/ employee, is going to be compensation for the services that the employee is performing and not a gift. So from the employer's perspective, the presumption is that they will be able to deduct the value of what they give to the employees, subject to any other special rules, such as restrictions on deducting expenses for entertainment, meals, et cetera.

Darrell (08:25):

So in the ideal case in what we're talking about with employee awards, the best result would be when the cost of the benefit is still deductible by the employer, but fits into an exemption that exempts, limits or defers the tax that's going to be paid by the employee and the employment taxes due from the employer. The term fringe benefits is commonly used to describe any type of benefit an employee gets from employment in addition to their wages or salary. There are a lot of exceptions to the general rule that anything that an employer pays the employee, including fringe benefits should be taxable. One example of situations where a fringe benefit is not taxed is group, life and healthcare insurance premiums that the employer may pay for the employee. Other exemptions apply for things like qualified adoption assistance plans, employer operated athletic facilities, qualified dependent care assistance programs, educational assistance, limited employee discounts, certain employee stock options, which of course aren't relevant for nonprofits,employer provided cell phones and a few others.

Darrell (09:45):

If the specific rules for each of these types of fringe benefit are followed, the fringe benefit may be exempt from the employee's taxes entirely. In other cases, such as retirement plans, their rules permit deferral of payment of the tax until years after the benefit was first funded by the employer. Now, the two type of fringe benefits that may be exempt from taxes that we're going to be talking about today are referred to as employee achievement awards or de minimis fringe benefits. The two tax exemptions have different criteria. I'll try to point out the differences as we work through the questions.

Sireesha (10:25):

Okay. So you mentioned those two potential exemptions, employee Achievement Awards and de minimis fringe benefits, which we'll talk about a little bit later on. What about in those situations where employers might provide a catalog to their employees and the employee can choose certain gifts upon a certain work anniversary. Are those employee tenure gifts taxable or would they fall within one of those two potential exemptions?

Darrell (10:55):

Okay. This, this question involves the rules on employee achievement awards and the use of a catalog, like you described, is actually intended to comply with one of the rules related to that. To be excluded from an employee's income as an employee achievement award. The awards there are rules that limit the purpose of the award, the timing of the award, and the amount of the award. To the extent these limitations aren't followed, the value of the award would be part of the employee's income, and the employer would have to include the value in the amount of the W-2 wages when it withholds the employee's taxes and reports them to the IRS, resulting in the employee paying income tax, social security tax, and Medicare tax on the award. And when computing the taxes that the employer pays the award would also be included. And that, of course, is the employer's portion of Social Security, Medicare, and the, then the additional unemployment tax that the employers pay. Now, assuming though that all the limitations on purpose, timing and amount are followed, IRS guidance specifically provides that for employment achievement awards, the employer can give the employee a certificate allowing a choice from a selection of items previously chosen by the employer. The items would have to meet the value limits applicable for the achievement award, which is $400 generally, or up to $1,600 in given under a qualified plan. And so the use of the catalog is designed to fit into that exception.

Sireesha (12:34):

So is there an exception for gifts specifically based on length of service?

Darrell (12:40):

Well, yes, in fact, there are two types of employment achievement awards, safety awards, and awards based on length of service. Both types of achievement award must be awarded as part of a meaningful presentation. Also, the awards can't be disguised wages or made under circumstances or conditions that would create a significant likelihood that they actually are disguised wages. If the requirements are met, the awards' value isn't included in the income of the employee, and while the employer is still able to deduct the cost of the award when computing its taxable income, the employer doesn't have to pay the Social Security Medicare and employment taxes on the value of the award. In addition to the amount limits I'm mentioned before, the $400 generally, or $1,600 for a qualified plan, there are limits on the timing of these length of service awards to employees. So the first award can't be made before the employee has been there at least five years.

Darrell (13:43):

And after the first award, additional length of service awards can be given only every five years or longer. The rule state that an eligible award must be to an employee who didn't receive another length of service award other than one of very small value during the same year or in any of the prior four years awards made more frequently would be taxable to the employee. Now, the other type safety awards have different restrictions, but the dollar limits on the award are the same. An award for safety actions will qualify as an achievement award and therefore exempt unless it is given to a manager, administrator, clerical employee, or other professional employee. Or if during the tax year, more than 10% of the employer's eligible employees that is those other than the managers, administrators, et cetera, have already received a safety achievement award. Again, other than those of very small value, that small value thing is kind of a recurring theme. Eligible employees must have worked full-time for at least a year prior to the award, but there are no other timing limitations. So to make that maybe a little more understandable let's use an example. If an organization had 50 employees eligible to receive safety awards and six were given safety awards in that year, the sixth award given would be taxable to the recipient because 10% of the eligible employees had already received excludable awards.

Sireesha (15:24):

Let's talk a little bit more about those dollar limits on the value of the awards. Could you go into more detail? For example, is the limit applied to all awards given an employee during their entire term of employment or only each time the award is given? In other words, are these lifetime limits? And what is a qualified plan that permits larger awards?

Darrell (15:54):

Okay. Well, the limits are not aggregated in terms of anything like a lifetime cap. The limit is applied each year, the employee is eligible to receive the award. The general dollar limit on an award is $400, but the limits are not separate for safety awards and length of service awards. So, if an employee receives in the same year, both the safety award and length of service award, and the total is over $400 or $1,600 at given under a qualified plans, then the amount over the exempt limit would be included in the employee's income and taxable. Now, the limit, increased limit that I mentioned for qualified plans is $1,600, but that really oversimplifies the concept. A qualified plan award is an achievement award for safety or length of service that's given as part of an established written plan or program. The regulation state that the plan should be permanent, meaning that it will only not be funded by the employer due to business necessity.

Darrell (17:00):

In addition, the plan can't favor highly compensated employees as to eligibility for the award or the benefit received in the award. A highly compensated employee is one who meets either of the following tests. Well, first test is they're a 5% owner or, or larger share during the year or the preceding year. Of course, again, ownership wouldn't apply to a nonprofit. And the other test is if the employee received more than a stated dollar amount, which is indexed for inflation in the preceding year, I think that amount was$130,000 for 2020. There is a little special rule that, that for larger organizations where the salary number doesn't have to be applied to an employee who makes more than that amount, but is not in the top 20% of employees compensated by the organization.

Darrell (18:04):

So the as I mentioned, the qualified plan permits awards up to $1,600, but it doesn't, the rules don't permit that every award under a qualified plan be up to that amount. It's a long way from it. Under a qualified plan, the average cost of all employee achievement awards given during the tax year can't be more than $400 and com. And in computing that average awards that exceed the plan limit of the $1,600 are also included. However, to figure the average cost, again, awards of nominal value can be excluded. So the, the short description of a qualified plan is that the individual award can't exceed $1,600, but the average of all achievement awards, even in those in excessive 1600 for given by the employer in that year, cannot exceed $400. So I think of the qualified plan as really just a variation on the general $400 limit. It allows some awards over $400, but other awards must be in amounts that bring down the average overall for the organization to $400 or less.

Sireesha (19:16):

And what if we have a particularly generous employer who wants to award someone with something valued over those limits?

Darrell (19:26):

Well, then the employee would have earned income on which they'd have to pay taxes in the amount by which the value of the award exceeds the limit. So, going over the limit, for example, a $500 award under a general plan as opposed to a qualified plan would result in a $100 of income that would be taxable to the employee, and the employer would have to deal with a hundred dollars of additional taxes the employer pays. So the employee doesn't have to put the entire value in their tax computation. It shouldn't be, shouldn't be reported on their W2. But, but there still is a tax consequence when you go over the limit.

Sireesha (20:11):

And now let's talk about a situation that is very common among smaller organizations, like the nonprofits we work with. If a smaller organization wants to provide a gift card, can an employer provide a gift card as a recognition or holiday gift to employees with no tax consequences?

Darrell (20:35):

Until you added that last little phrase, I was getting ready to say yes, but <laugh>, but now the answer is "no". So yes, it would be very easy for a smaller organization, I think, to be able to go down to the store and just pick up a, a bunch of $50 gift cards. And but the tax law for both the Achievement Awards and de minimis fringe benefit awards precludes the use of cash or cash equivalence for giving an exempt award. Now if I'm an employee and somebody's going to give me $50 gift card, I take that even if I have to pay taxes over it, over getting nothing. But if the rules are followed and I can get something of value that I enjoyed and not have to pay taxes on it, obviously that that would be a better situation.

Darrell (21:30):

So the, the nuance here is that while cash and cash equivalents such as gift cards are not allowed, you, an employer could give a gift certificate for a specific item of nominal value. For employee achievement awards, the law specifically requires that the awards can't be cash, cash equivalents, gift cards, gift coupons, or gift certificates, excuse me, other than amounts conferring only the right to select and receive specific tangible personal property from a limited array of items pre-selected or pre-approved by the employer, that's the catalog we talked about earlier. In addition, the awards can't be vacations, meals, lodging tickets to theater or sporting events, stocks, bonds, other securities and similar items. And again, this is for the Achievement Awards.

Darrell (22:24):

The rules for de minimis fringe benefits aren't quite as restrictive. They do would permit theater or sporting event tickets if they're within the de minimis value limits. But not season tickets, although I don't know how many season tickets you could get for such a small amount. We're gonna talk about the de minimis fringe benefit value limits in, in a little bit. But again, for fringe bene, the de minimis fringe benefits, just like achievement awards, cash and cash equivalents generally can't be awarded and be exempt.

Sireesha (22:57):

Darrell, so it sounds like there are clearly a lot of restrictions and exemptions. What option does an employer have to provide gifts or recognition for employee?

Darrell (23:09):

Well, again, the general theme is that they can give items of tangible personal property. And if the recognition is for length of service or safety achievements, the employer can select some sort of a meaningful gift valued less than $400 or the $1,600 averaged down to $400 overall, under a qualified plan. IRS publications, for example give u use an employer giving sets of golf clubs as an example, when they're discussing the concept of only having to pay tax on the value over the limits. I think they, one employee gets a $350 set of golf clubs and another employee got a $500 set of golf clubs, and then the examples work through the tax consequences. Interestingly, at least I found it interesting that the publications also mentioned that achievement award gifts might be engraved or otherwise reference the recipient of the award. Now that's not a requirement for the exemption. And I just thought it was interesting cuz the publications also specifically mentioned that the cost of that engraving doesn't count toward the limit on the value of the award.

Sireesha (24:30):

So those are for serv length of service or safety achievements. What about gifts for other reasons?

Darrell (24:38):

Okay, and this gets into the other category that I've been mentioning that de minimis fringe benefits. So again, for these awards or gifts, cash and cash equivalents cannot be excluded. The, the rules define depends. Fringe benefits as property or service provided to an employee that has so little value taking into account how frequently the employer provides similar benefits to its employees, that accounting for it would be unreasonable or administratively impracticable. Cash and cash equivalent fringe benefits, which we've talked about a little bit, no matter how small, are never excludable as a de minimis fringe benefit. However, meal money and local transportation fair if provided on an occasional basis and because of overtime work might be excluded. The key is that the amounts have to be very small and given only occasionally. Now, the concept of de minimis fringe benefits, you know, it is expanded to cover other situations as well. And, and I think we're gonna end up talking about some of those as we go

Sireesha (25:49):

Okay. And you talk about the amount being small for these de minimis fringe benefits, how small is small? Is that under $75?

Darrell (26:02):

Well, unlike the rule for Achievement Awards where the guidance specifically says the limits $400 or the limit is $1,600, if you average down to 400, there isn't any official rule on exactly what the limit on the amount of a de minimis fringe benefit is. Now though it, however, in in their publications the I r s references some rulings that have been given to taxpayers in the past where $100 was not treated as de minimis. So for, I'd be comfortable excluding a gift with a value of around $75 if the other criteria for de minimis fringe benefits are met, you know, not being cash or cash equivalents and not routine and commonplace as to be considered no longer minimal.

Sireesha (26:50):

And can you share with us some examples of de minimis benefits?

Darrell (26:55):

Sure. I'm glad you asked this because the, I think the examples might help us understand better just how expansive the concept of taxing any compensation an employee receives could be. But for this, this rule the i r s publication gives the following examples of items that would qualify as de minimis fringe benefits and therefore not taxable. And the list includes group meals, employee picnics, theater or sporting event tickets, coffee, donuts or soft drinks, flowers or fruit for special circumstances, traditional birthday and holiday gifts, but not cash that have a low fair market value, commuting use of the employer's car, but no more than once a month. And then occasional reimbursement for overtime meal expenses. But again, the there are limits here. Can't be company policy or pursuant to a union contract or the reimbursement would be taxable. Some other types of things that I've seen referenced in the materials were an employee's use of a copier at work and you know, office supplies that accidentally got get used for personal use. Under, under the general "everything would be taxed theory," those very small items would be included in the employee's income. But fortunately, because of the de minimis fringe benefit rule, the employer and employee don't have to keep track of all of that.

Sireesha (28:36):

Yeah. That, that would be quite challenging if they had to keep track of that. In the list that you just provided of dominous benefits, you mentioned group meals. May an employer take employees out to a meal, and what if it's a situation where spouses are attending the meal and the employer pays for their meal as well?

Darrell (28:59):

Yes, that generally should be okay. Occasional meals including attendance by guest are permitted to be excluded. But remember, they can't be lavish or overly expensive. The publications also reference holiday parties as following within the de minimis fringe benefit exclusion. Something very helpful of course toward the end of the year.

Sireesha (29:23):

And let's talk about another specific type of gift. What about tickets? Like tickets to an event? Does it matter if the gift given to the employee is a ticket that was donated to the nonprofit employer?

Darrell (29:39):

No, I don't think it matters whether the tickets were donated or to or purchased by the nonprofit employer. If they're given to an employee, they would need to follow within the de minimis fringe benefit rules to be exempt. Again, occasional gifts of individual event tickets of nominal value would not be taxed. Tickets worth more than nominal value would be problematic because they wouldn't qualify as de minimis. The regulations for Achievement Awards, again, length of service or safety, were the dollar amounts are greater preclude giving awards in a form of theater and sporting event tickets. But remember that the guidance also suggests that in any type of award de minimis or achievement season tickets are not permitted. Of course, you probably couldn't get season tickets for de minimis value anyway, but ...

Sireesha (30:36):

<Laugh>, that makes sense. Yeah. And now Darrell, you provide a lot of great information here. If our listeners have more questions on the topic, are there any resources online or written references that you can recommend to them?

Darrell (30:51):

Yes. Here, I'll put in a plug for my former employer. The IRS website, irs.gov has a lot of information on this topic. Unfortunately there's so much tax information on the website, it's not always easy to find guidance on a specific topic right away. For employment related information, I would recommend a few publications such as the Employer's Tax Guide, fringe Benefit Guide, and the Business Expense Guide. They're written primarily for the perspective of the employer, but even employees could read them to better understand how their withholding works and the amounts they're paying for Social Security and Medicare taxes.

Sireesha (31:30):

And for our listeners, we will include links to those publications on the webpage for this episode. So please take a look there for the relevant IRS publications. Darrell, this is all such great insight. Thank you for providing some clarity and guidance for nonprofits on the tax considerations of employee gifts. I appreciate you sharing your time and expertise with us today.

Darrell (31:59):

Well, you're most welcome. I would remind folks that the information that we discussed today was based on review of the tax law and the IRS publications at the end of the year 2022, and they could be changed in the future. So people need to consider that. Thank you very much.

Sireesha (32:18):

We hope that you found this episode of the PBPA Podcast to be informative and helpful. We add new episodes every month with short conversations about general, yet important legal information for Georgia nonprofits. Remember that this is not legal counsel. Talk to your attorney about your organization's specific concerns. Thanks for tuning into the PBPA Podcast. And to all nonprofits listening out there, thank you for all the good work you continue to do in our community.