Tax Consequences of Giving Gifts to Employees

This is the time of the year when many employers give deserving employees a reward for a job well done, or acknowledge a good working record.

It also may be an occasion to say goodbye to long-time workers who are retiring.

De minimis fringes

For FICA and income tax withholding purposes wages do not include any benefit provided to the employee if the benefit is excludable from his or her gross income under Code Sec. 132 as a de minimis fringe benefit.

In general tax-free de minimis fringes are benefits provided by employers that are offered infrequently and have a fair market value (FMV) so small that it is impractical and unreasonable to account for them.

All of the following are treated as de minimis fringes which are tax-free to the employee yet deductible in full by the employer:

- Traditional birthday or holiday gifts of property (not cash) with a "low fair market value";
- Presents such as books or flowers provided to employees under special circumstances;
- An occasional cocktail party, group meal or picnic for employees and their guests, or occasionally giving out theater or sporting event tickets.

The Tax Reform Act of 1986 declares that the exclusion for de minimis fringe benefits "can apply to employee awards of low value, including traditional awards such as a gold watch upon retirement after lengthy service for an employer".

The proposed regulations which have yet to be finalized some 31 years later provide that under appropriate circumstances, a traditional retirement award will be treated as a de minimis fringe. For example assume that an employer provides a gold watch to each employee who completes 25 years of service with the employer. The value of the gold watch is excluded from gross income as a de minimis fringe.
For purposes of the tax-free de minimis fringe benefit rules "employees" include partners, members of LLCs taxed as partnerships, and more-than-2% S shareholder-employees.

If an employer gives cash, gift certificates, debit cards or similar items that are convertible to cash, the value is considered additional wages regardless of the amount.

For example where an employer that had been giving employees hams, turkeys, or gift baskets as a holiday gift but then switched to giving holiday food gift coupons with a face value of $35 that were redeemable at a number of grocery stores the IRS has concluded that the coupons were taxable to its employees, and subject to employment taxes and withholding taxes.

If the coupons were nontransferable and convertible only into a turkey, ham, gift basket, or the like at a particular establishment, they would not be treated as cash equivalents.

**Employee achievement awards**

An employee achievement award is tangible personal property that is awarded for one of two purposes:

1. *Length of service.* An award won't qualify as a length-of-service achievement award if the employee either
   a. Receives the award during the first five years of employment; or
   b. Received a length-of-service award (other than one of de minimis value) during the year or in any of the prior four years.

2. *Safety achievement.* An award will not qualify as a safety achievement award if it is given to:
   a. A manager, administrator, clerical employee, or other professional employee; or
   b. More than 10% of the employees during the year, excluding those listed above.

Either type of award must be made as part of a meaningful presentation, and under conditions and circumstances that do not create a significant likelihood of disguised compensation.

Awards of cash, gift certificates or other nontangible items do not qualify as employee achievement awards, however, under proposed regulations, tangible personal property would include a nonnegotiable certificate conferring only the right to receive tangible personal property.
If a certificate entitles an employee to receive a reduction of the balance due on his account with the issuer of the certificate, the certificate would be a negotiable certificate and would not be tangible personal property.

Vacations, meals, lodging, tickets to theatre and sporting events, stocks, bonds and other securities also would not be considered tangible personal property.

The IRS has a $25.00 limit per person per year as to what is considered de minimis.

**Qualified vs. Nonqualified plan award**

An employee achievement award can be a qualified plan award or a nonqualified plan award.

To be a qualified plan award the employee achievement award must be made as part of an established written plan that does not discriminate in favor of highly compensated employees as to eligibility or benefits.

A highly compensated employee is an employee who:

1. Is a 5% owner at any time during the determination year or the preceding year, or
2. For the preceding year, received more than $120,000 (in 2017 or 2018) in compensation from the employer and, if the employer elects, also was in the "top-paid group" (top 20%) of employees for that year.

Additionally an award is not a qualified plan award if the average cost of all the employee achievement awards (other than those of minimal value) given during the tax year (that would be qualified plan awards but for this limit) is more than $400.

An employee achievement award that is not a qualified plan award is a nonqualified plan award.

**Employer's deduction for employee achievement awards**

The employer's deduction for the cost of all nonqualified plan awards made to any one employee during the tax year cannot exceed $400 annually.

The employer's total deduction for the cost of employee achievement awards, including both qualified and nonqualified plan awards, made to any one employee during the tax year cannot exceed $1,600.

If the award is made by a partnership these limits apply to the entity as well as each member of the partnership.

**Employee's exclusion for employee achievement award**
If the cost of an employee achievement award is fully deductible by the employer under the above rules the employee can exclude the entire FMV of the award.

**Taxable portion of employee achievement award**

If the award exceeds more than the amount the employer can deduct the employee must includes in income the larger of:

1. That part of the cost of the award that the employer can't deduct (up to the award's FMV); or
2. The amount by which the FMV of the award is more than the amount the employer can deduct.

To illustrate, an employer makes a qualifying length of service award to an employee in the form of a necklace that cost the employer $425 and is worth $475. The deduction limit applicable to the award is $400.

The amount includible by the employee in income is the greater of:

   a. $25 (the difference between the cost of the item ($425) and the employer's deductible amount of $400) or
   b. $75 (the amount by which the FMV of the award ($475) exceeds the employer's deductible amount of $400).

As a result $75 is includible in the employee's income.

The remaining portion of the FMV of the award (the $400 amount allowable as a deduction to the employer) is not included in the gross income of the employee.

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