Awards and Prizes

Generally, the value of an award or prize given by an employer is taxable to an employee as a wage, included on the Form W-2, and subject to Federal income tax withholding, social security and Medicare. *IRC 74; IRC 3121(a)(20)*

If the employer pays the employee's share of taxes on an award, these amounts are additional wages to the employee (except for agricultural and domestic services) and are subject to all payroll taxes, as discussed above.

Nontaxable Awards

There are three types of noncash awards that may be excluded from income. Each category has specific requirements that have to be met in order to be excludable. These categories are:

- Certain prizes or awards transferred to charities
- De minimis awards and prizes
- Certain employee achievement awards

Any other awards, such as recognition rewards (unless qualifying de minimis fringe benefits), are taxable. A worksheet to compute the taxability of an award to an employee is provided in Publication 535, Business Expenses.

The three categories are discussed in detail below.

Nontaxable Prizes or Awards Given to Charities

Certain prizes and awards given for charitable, scientific, artistic or educational achievement are not taxable to the recipient if transferred to a charitable organization. *IRC §74(b)*

Examples: Nobel Peace Prize and Pulitzer Prize for Journalism

Requirements for Exclusion

- Award is for achievement
- Recipient is selected without entering any contest
- No substantial future services are required
- Recipient transfers the award to a charitable (IRC §170(c)) organization prior to receiving the benefit

Example: A college instructor is chosen as teacher of the year by a national education association. He is awarded $1,000, which he directs the education association to transfer to a college scholarship fund at the institution where he teaches before accepting it. The award is not taxable to the college instructor.

Nontaxable De Minimis Awards and Prizes

A prize or award that is not cash or cash equivalent, of *nominal value* and is provided *infrequently* is excludable from an employee's wages. Prizes or awards that are given frequently to an employee do not qualify as an excludable de minimis award, even if each award is small in value. *IRC §132(e)*

Examples of Excludable De Minimis Awards

- Nominal gifts for birthdays, holidays
- Holiday turkey and hams
- Flowers, plaques, coffee mugs for special occasions
- Gold watch on retirement
- Parking for employee of the month, if value is less than QTFB limit

Nominal for this purpose means small in value, relative to the value of total compensation. There is no set dollar amount in the law for nominal prizes or awards. A $25 limit is imposed on business gifts. The IRS has given advice at least once that a benefit of $100 did not qualify as de minimis. *ILM 200108042*

Cash equivalent means readily convertible to cash, such as a savings bond or gift certificate.

Example: An employer provides dinner at an annual awards banquet for employees. The regulations specifically mention that occasional group meals are considered nontaxable fringe benefits. *Reg.§1.132-6(e)(1)*

Cliff Provision

If an employer provides an award that exceeds either the value or frequency limitations for de minimis fringes, the entire award is included in the employee's wages, not just the portion that exceeds the de minimis limits. *Reg. §1.132-6(d)(4)*

Employee Achievement Awards

An employee achievement award is an item of tangible personal property for **length-of-service or safety.** (Cash awards are always taxable.) In order to be excludable from wages, special requirements and dollar limitations must be met. A qualifying award:

- Must be a given for length-of-service or safety
- Cannot be a disguised wage
- Must be awarded as part of a meaningful presentation
- Must be an item of tangible personal property (Cannot be cash, cash equivalent, vacations, meals, lodging, theater or sports tickets, stocks, bonds.)
- Must meet other special requirements and limitations, discussed below. *Reg. §1.274-8(c)*

Note*:* Taxable if cash or cash equivalent, or if over certain dollar limits

Length-of-Service Awards

An award will not qualify as a length-of-service award if either of the following applies.

- The employee received the award during his or her first 5 years of employment.
- The employee received another length-of-service award (other than one of very small value) during the same year or in any of the prior 4 years.

Note: A traditional retirement award is an exception to the 5-year rule. *Reg. §1.274-8(d)(2)*

Safety Achievement Awards

An award will not qualify as a safety achievement award if either of the following applies.

1. It is given to a manager, administrator, clerical employee, or other professional employee.
2. During the tax year, more than 10% of the employees, excluding those listed in (1), have already received a safety achievement award (other than one of very small value). Eligible employees must have worked full-time for a minimum of one year prior to the award. *Reg. § 1.274-8(d)(3)*

Example: If an agency has 50 eligible employees and 6 receive safety awards, the 6th award is taxable because 10% of the eligible employees have already received it.

Qualified Plan Award

An award is a qualified plan award if it is:

- Made under an established written plan, and
- Does not discriminate in favor of highly paid employees, and if
- The **average cost** of **all** employee achievement awards (both qualified and nonqualified awards for length of service and safety) made by the employer during a single year does not exceed $400. Awards of $50 or less are not included in computing the average. *Reg. § 1.274-8(c)(5); IRC §414(q)(1); Reg. §1.274-8(c)(5)*

Generally, if an award is taxable to an employee, it is valued at the fair market value (FMV). The taxable amount of an award to an employee depends on whether the award is made under a qualified or nonqualified plan, whether the cost of the award to the employer exceeds the dollar limitations, and the FMV of the award. *IRC § 274(j)(2)*

Example: In 2009, an agency presents employee length of service awards to 6 employees for a total cost to the employer of $1,800. The average cost of all awards is $300 ($1,800/6). Since the average cost of all awards does not exceed $400, the awards are considered qualified plan awards provided there is a written plan that does not discriminate in favor of highly paid employees.

Nonqualified Plan Awards

A nonqualified plan award is one ***not*** made under a qualified plan. Nonqualified awards can discriminate in favor of highly paid employees. *Reg. §1.274-8(c)(5)(ii)*

Regardless of the cost of an award or its FMV, the following awards are taxable as wages to an employee:

- Cash or cash equivalent awards, such as savings bonds or general merchandise gift certificates.
- Recognition awards, cash or non-cash, for job performance unless they are qualifying de minimis fringe benefits
- Awards for outstanding customer service, employee of the month, highest productivity
- Achievement awards, cash or non-cash, that do not meet the requirements for excludable treatment
- Awards for length of service or safety achievement that do not meet certain specific requirements and limitations.
- Non-cash prizes (unless de minimis) won by employees from random drawings at employer sponsored events. *Reg. §1.274-2(c)(4)*

Dollar Limitation

The maximum amount of excludable awards to a single employee during a calendar year is limited to:

- $400 for awards made under a nonqualified plan, or
- $1600 in total for awards made under both qualified and nonqualified plans

Example: An employer only makes awards to employees that are non-cash qualifying length-of-service or safety awards. In order to avoid the extensive recordkeeping and tracking required for determining the taxability of awards, the employer has a policy of not making awards that exceed $400 per employee annually. In this situation, none of the awards would be taxable to the employees.

Example: An employee receives two employee achievement awards during the year. The cost and FMV of the awards were the same.

	Cost and FMV
Nonqualified plan award of a watch	$ 400
Qualified plan award of a stereo	1,350
Total awards	$1,750
Less: Annual limitation	(1,600)
Taxable portion of awards	$ 150

Cost Exceeds Dollar Limitations - Excess Deduction Award

Generally, if an award is taxable to an employee, it is valued at the fair market value (FMV). If the cost to an employer for an award exceeds the plan dollar limitations, either $400 (non-qualified plan) or $1,600 (qualified plan), then the amount included in wages is the *greater* of:

1. The part of the employer's cost that is more than the plan dollar limitation (but not more than the FMV), or
2. The amount by which the FMV exceeds the amount of the plan dollar limitation. *Reg. §1.74-2(b)*

Example 1: Excess Deduction Award

An employer pays $520 for golf clubs given to an employee as a nonqualified plan employee achievement award. The fair market value of the award (golf clubs) at the time it is given to the employee is $750.

	Cost	FMV
Award	$520	$750
Less: Limitation	400	400

	Cost	FMV
Excess over limitation	$120	$350

The employee is taxed on $350, the greater of the cost less the limitation or the FMV less the limitation. If the award had been a qualified plan award, the employee would not have been taxed on any of the value of the award.

Example 2: Excess Deduction Award

An employer pays $395 for golf clubs given to an employee as a nonqualified plan employee achievement award. The fair market value of the clubs at the time the award is given to the employee is $450.

	Cost	FMV
Award	$395	$450
less: Limitation	400	400
Excess over limitation	$ 0	$ 50

Since the employer's cost of the award does not exceed the $400 limitation for nonqualified awards, the employee is not taxed on the value of the award. *Reg.. §1.74-2(b)*

Awards Funded by Third Party

If funds for awards or prizes are provided by an outside party, the award is taxable in the same way as if provided directly by the employer. If the funds are turned over to the employer to select and distribute the awards, the employer is responsible for all applicable payroll taxes and withholding. *IRC §3402(d)*

Example: A bank provides funds to a state agency to support a special performance award program. The agency chooses the recipients and distributes the awards. The value of the awards are additional compensation to these employees and reportable on their Forms W-2, subject to payroll taxes and withholding. This answer would be the same even if the outside party were a nonprofit organization or an educational foundation.

In the case where the outside party selects and distributes the award directly to an agency employee without any direction or decision making from agency personnel, then the award is income to the recipient and must be reported. The outside party would be required to furnish a Form 1099-MISC to the recipient if the amount is $600 or more in a calendar year.

Example: A television set, donated by a business to a state agency, is awarded through a random drawing to an employee. The fair market value of the television would be considered taxable wages to the employee. Prizes in a random drawing of employees are considered wages. A television set is not considered a de minimis benefit.

If an agency pays the taxes on an award, the tax paid on behalf of the employee is taxable under the "grossing up" procedure discussed earlier. The additional payment for the taxes is a taxable item and must be included on the employee's Form W-2 in the year the payment was made. See section 7 of Publication 15-A, Rev. Proc. 81-48 and Rev. Rul. 86-14.

Example: Special duck prints donated by artists are given away as awards to employees. For purposes of determining the taxable value, the FMV can be determined by an appraisal, by establishing the sales price of similar prints by the artist, or by any other reasonable method. The taxability of the value of the prints to the employees depends on the type of award, dollar limitations and other specific requirements.