



To Win or Not to Win!

Article on Prize and Awards

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Background

The law on 'prize and awards' took incipience much before the codification of the Internal Revenue Code of 1986.⁴ However, the passage of the Tax Reform Act of 1986 ("Act") brought along with it certain amendments that aimed at making the existing law more tax neutral and economically fair. While the original congressional intent on prizes and awards continues to hold true post the Act, a few revisions were made to bring about more clarity and uniformity in treatment of the taxpayers. The following are the highlight of the provisions of the law as it stands today and how it may impact taxpayers.

Introduction

The statute has always required taxpayers to include in their gross income amounts received as prizes and awards by default. These may range from contest winnings, door prizes, radio and television giveaway prizes to awards received during the course of employment.⁵ The law, however, allows for tax relief in two situations: payments transferred to charity and to certain employee achievement awards.

- Payments Transferred to Charity

One of the exceptions to the general rule of taxability of prize award money is if the award money is diverted at the source to a governmental unit or charitable organization. The prerequisite to qualify for the exclusion is that, it is in recognition of past religious, charitable, scientific, educational, artistic, literary, or civic achievement and

- The recipient did not undertake any action to be a part of the contest;
- The payment is not contingent on any subsequent performance by the recipient.⁶
- Decline of Award

Another instance where prize money is tax-exempt is where the awardee refuses or rejects the award altogether. This doctrine emerged more from Rev. Rul. 57-374, 1957-2 CB 69 rulings rather than the Statute.

- Employee Achievement Awards

Another exception to the general rule is when an item of

tangible personal property is presented to an employee in appreciation of either length of service or safety achievement⁷, provided it is awarded as part of a meaningful presentation and is not merely disguised compensation.⁸ If deemed to be disguised compensation, the employment-productivity related awards, performance excellence awards, etc. are includible as wages and consequently subject to withholding of tax.



⁶ IRC §74(b)

⁷Length of service award: should not be made in employee's first five years of employment or should not have already been presented in the current or any of the preceding four years. Safety achievement: Must be offered to eligible employees (employees other than those in positions not engaged in work involving significant safety) or must not be made to more than 10 percent of the employer's eligible employees.

⁸ Reg .1.274-8(c) (3) Meaningful presentation: Whether an award is presented as part of a meaningful presentation is determined by a facts and circumstances test A ceremonious observance emphasizing the recipient's achievement may suffice. 1.274-8(c)(4) Disguised compensation : An award will be considered disguised compensation, if the conditions and circumstances surrounding the award create a significant likelihood that it is payment of compensation

⁴ IRC § 74

⁵ Reg 1.74-1(a)(1)

Moreover, the exception applies only to tangible awards and not to cash, gift certificates and other items akin in nature to these.

Not all of the qualified receipts are disregarded from gross income. The law limits the amount that can be excludable from income. In case of employment achievement awards, this has been interlinked with the amount an employer can claim as a deduction⁹ or prize and awards, which is prescribed at \$400 and increases to \$1,600 if the award is disbursed under a “qualified plan”.¹⁰ The deductibility treatment differs when the cost of the award is less or more than the ceiling limits, both of which are examined in the following paragraph:

- Cost Less than FMV

If the cost of the award is below the ceiling limits, the award is excludible irrespective of the FMV of the award. However, taxpayer must note that Fair Market Value (“FMV”) that is disproportionate vis-a vis the cost will be designated as ‘disguised compensation’ and hence taxed.

Illustration: An employer makes a length of service achievement award (other than a qualified plan award) to an employee in the form of a watch, and all other conditions of IRC §274(j) are met. Assume further that the cost of the watch to the employer is \$375, and that the FMV of the watch is \$415. The full FMV value of \$415 is excludable from the employee's gross income. If on the other hand, the FMV was \$1,000, the same would be perceived as disguised compensation and the full amount of \$1,000 would be subject to tax.

- Cost Exceeds FMV

In a situation, where the cost of the award to the employer exceeds the dollar limitations, the gross amount must include greater of-

- Excess cost over threshold, limited to FMV

- Excess of FMV over the threshold

Illustration: Employer C pays \$500 (FMV of \$475) for a watch (not a qualified plan) that goes as a safety award to B, an eligible employee. C's deduction is limited to \$400. Therefore, B must include as income the greater of (1) \$100, which is the difference between the watch's cost (\$500) and C's \$400 deduction limit (Limited to FMV=\$475), or (2) the excess of the watch's FMV over C's \$400 deduction. B includes \$100. Instead, if FMV is \$600, B includes \$200 [Greater of \$100 or \$200(\$600-\$400)].

Certain Disqualifying Charitable Contributions

Another closely related issue is when purported charitable contributions are



made in connection to fund-raising events such as purchase of raffle tickets for the benefit of the charitable organization.¹¹ In such cases, the courts have held that the presence of a chance of receiving *something in return* results in a lack of a full deduction for the entire donation.

This was clarified in Rev. Rul. 67-246, 1967-2 CB 104. In explaining the principles of qualifying charitable contribution, the IRS maintained that the basic rule for a deductible charitable contribution is making of a gift without “adequate consideration”. Thus, when a raffle ticket is bought, the presumption is the purchaser receives a value in return, i.e., a chance to win. Any excess payment may however, be claimed as a deduction, if the following is proven:

- Evidence that the payment exceeds value of consideration received;
- That the excess payment was intended to be a gift.

⁹ IRC § 274(j)

¹⁰ An established written plan or program of the taxpayer that doesn't discriminate in favor of highly compensated employees as to eligibility or benefits.

¹¹ Charitable contributions are dealt under § 170. However, due to the nexus of charitable fundraising events with prizes and awards the issue has been discussed to throw light on the tax implications to donors

The above principle was explained in example 5 of the ruling, where a \$5 raffle to win an automobile was held as non-qualifying contribution. The court theorized that

“Amounts paid for chances to participate in raffles, lotteries, or similar drawings or to participate in puzzle or other contests for valuable prizes are not gifts in such circumstances, and therefore, do not qualify as deductible charitable contributions.”

What This Means To You?

Implications to an Individual



The law covers all prizes and awards unless exclusion applies. Winnings from participation in contests which are held as marketing gimmicks,

such as free car, TV etc., are all taxable. There are certain crucial compliance issues, the adherence to which may mitigate an unwarranted tax exposure-

- In case of non-taxable awards (civic, religious etc.), timing of the designation to charity by the recipient is important. This is fulfilled by the recipient furnishing a written form to the payer indicating the intent before an impermissible¹² use of the award occurs.¹³
- Furthermore, with regard to awards received as an employee, the income exclusion rules must be met. Awards having a direct relationship with employment-related bonuses, awards for outstanding service, highest productivity or job performance are generally taxable. Cash or cash equivalent awards, such as savings bonds or general

merchandise gift certificates by an employer are always taxable.

- Tax must normally be withheld on taxable employer awards. A failure to do so may cause undue tax burden at the time of tax filing for the employee.
- The provisions of this law would not apply to any de-minimis fringe benefits, which continue to be tax free.¹⁴

Implications to Businesses and Employers

Some key pointers for an employer are:

- The law specifically precludes any achievement awards by a sole proprietorship to the sole proprietor from the purview of this code section.¹⁵
- Employers generally have to adhere to the dollar limits set by the law in claiming a deduction. For partnerships, the limit is applied separately to the partnership and individual partners.¹⁶ Deduct payroll taxes on all prizes and awards includable in employees' income.
- Prizes and awards are distinct from gifts and therefore, the two cannot be clubbed or interchanged for tax purposes.¹⁷
- If you are a tax-exempt business, the exclusion limitation is based on the deduction that would be allowed if the employer were subject to tax.¹⁸

Conclusion

The foregoing paragraphs provide an overview of the tax issues surrounding prizes and awards in context of an employee and an employer. With the intricacies, rules and regulations surrounding each case, it is imperative that the taxpayer makes a

¹²Impermissible uses include spending, investing depositing or use of property with recipient's permission.

¹³ The IRS has issued Rev Proc Rev. Proc. 87-54, 1987-2 CB 669, containing guidelines on how to assign the award to a donee and states that the designation should be made before the prize or award is actually presented by the payor to the recipient. If it's not possible to do so (as in an unexpected presentation) the recipient must return the prize or award to the payor before the item is used and certify in the designation document that he or she made no use of it before its return.

¹⁴The term means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable (IRC§ 132(e))

¹⁵ Prop Reg § 1.74-2(d)(1)

¹⁶ IRC§ 274(j) and 274(j)(4)(A)

¹⁷ Under section 274(b), gifts have a separate deductible limit of \$25 per recipient employee.

¹⁸ IRC§ 74(c)(3)

closer examination of the receipt and how it must be treated. In addition, donations must be rechecked to ensure that they have no element of return consideration. Also, for an employer, characterization of the income is crucial - including the withholding requirements. Although, the tax net is far and wide, it is evident that with some planning, a taxpayer can avoid the imposition of taxes in many circumstances.