

The tax consequences of point-based employee reward programs.

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The incentive merchandise and travel industry has experienced rapid growth in recent years. According to a study released by the Incentive Federation in 2007, the amount spent on incentive merchandise and travel in 2006 was \$46.1 billion--almost double the \$26.9 billion spent in 2000. (1) The study found that more than one in three U.S. companies used incentive travel or merchandise to recognize or motivate employees and that one of the biggest trends in the incentive industry was the popularity of incentive programs for nonsales employees. In 2000, nonsales employee programs accounted for just 13% of incentive spending, but by 2006 such programs accounted for nearly one-third of all incentive spending. One of the fastest-growing formats for incentive spending is point-based employee recognition programs.

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Modeled on the affinity programs sponsored by airlines, credit card companies, and banks, an effective point-based employee recognition program is highly visible and can help create a culture of reward and recognition, even on a lean budget. In a typical program, managers are allocated a certain number of points on a monthly basis that can be awarded to employees for accomplishments that help meet the employer's business objectives. Employees accumulate points, which they can redeem for merchandise in an incentive catalog. Common rewards include gift certificates, merchandise, and travel awards. Because they can spontaneously award points, supervisors are able to recognize even small acts, which helps to foster a culture of recognition.

As Michael Levy, president of Online Rewards, a Dallas-based incentive solutions provider, explained, "The constraints of general remuneration and compensation plans make it difficult for companies to develop innovative employee rewards programs for the mainstream. Noncash (i.e. travel or merchandise rewards) provides significantly greater flexibility and the option for creativity as it applies to developing performance-based employee rewards programs." (2) Levy has also observed that "even with the downturn in the economy, top executives at many of the Fortune 500 companies are recognizing the opportunity of investing valuable resources into creating a culture of reward and recognition in their organizations. Managers are realizing that it is important to engage their existing workforce now, so that when the economy does improve, their employees choose to stay because they feel valued." (3)

Incentive solutions providers can not only assist employers in designing and implementing recognition programs but can also administer programs for them. Providers can customize programs for the employer, and employees are often provided internet access to their accounts, where they can review available rewards and redeem points. The incentive solutions providers generally give employers a summary of the rewards that have been redeemed by their employees and will invoice employers for the cost of such rewards. It is

the employer, however, who is responsible for the payroll tax consequences associated with the programs.

The specific provisions of a reward program will determine its tax consequences. Some programs may be structured to provide nontaxable benefits in the form of employee achievement awards under Sec. 74(c), which permits an employee to exclude from gross income the value of tangible personal property awarded for length of service or safety if the cost to the employer of the award does not exceed \$400. A trucking company, for example, may find a program designed on the safety criteria of Sec. 74 to be highly effective in motivating its drivers.

Other programs may be structured to provide nontaxable fringe benefits under Sec. 132 (e.g., no-additional-cost services, qualified employee discounts, working condition fringe benefits, de minimis fringe benefits, qualified transportation fringe benefits, qualified moving expense reimbursements, qualified retirement planning services, and on-premise gyms and athletic facilities). For example, a hotel chain might design a program that awards free lodging (a no-additional-cost service) to employees on a nontaxable basis. (It should be noted, however, that some nontaxable fringe benefits are subject to nondiscrimination requirements, which if not satisfied will cause benefits provided to highly compensated employees to become taxable. A failure of the nondiscrimination requirements, however, does not affect the non-highly compensated employees who receive benefits or the employer's deduction for the cost of the benefits.) Most employers, however, will find that the narrow benefits permitted under Sees. 74 and 132 cannot effectively achieve their goals and therefore will opt for an alternative plan design, even if it causes the benefits offered under the plan to be taxable. This article explores the tax consequences of such taxable programs.

Existing Revenue Rulings

The IRS has issued at least two rulings on the compensatory use of items redeemable for noncash rewards of the employee's choosing. In Rev. Rul. 68-365, (4) a corporation adopted a stamp plan and began giving stamps, instead of money, to its employees in payment of commissions. The stamps, commonly referred to as trading stamps, had a distinctive printing and color, were the same as stamps distributed by local merchants when making retail sales, and were redeemable for merchandise at designated redemption centers established by the supplier of the stamps. The question presented in the ruling was whether commissions paid in trading stamps are within the definition of "wages."

The revenue ruling noted that the term "wages" means all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash, with certain exceptions not here material. It went on to note that "the applicable Employment Tax Regulations [Regs. Sees. 31.3121(a)-1(e), 31.3306(b)-1(e), and 31.3401(a)-1(a)(4)] provide, in part, that when remuneration is paid in items other than cash, the remuneration is computed on the basis of the fair value of the items at the time of payment."

Accordingly, Rev. Rul. 68-365 concludes that the fair value of trading stamps distributed by the corporation to its employees in payment of the commissions is includible in wages for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages.

In the facts of Rev. Rul. 70-331, (5) a distributor issued "prize point checks" redeemable for merchandise to salesmen-employees of his dealers. Each salesman-employee selected the merchandise award he desired and sent an order form together with sufficient prize point checks to cover the order to the distributor. The merchandise award was sent directly to the salesman. The ruling held that the fair market value (FMV) of the prize points was includible in the employees' gross income at the time the prize points were paid or otherwise made available to them, whichever was earlier.

Observation: Although it does not appear that the prize points in Rev. Rul. 70-331 were transferable, the IRS failed to distinguish them from the trading stamps in Rev. Rul. 68-365. While the trading stamps in Rev. Rul. 68-365 were "the same as stamps distributed by local merchants when making retail sales, and ... redeemable for merchandise at designated redemption centers established by the supplier of the stamps," and the IRS appears to have viewed them as cash equivalents (e.g., taxable upon receipt), it is the author's opinion that the prize points in Rev. Rul. 70-331 were not cash equivalents, and therefore Rev. Rul. 70-331 should have contained a thorough analysis of the time at which income should be recognized (e.g., whether the points were taxable at grant or whether the merchandise was taxable when received) and the related issue of valuation.

Years ago, the IRS faced similar timing and valuation issues in attempting to tax the personal use of frequent flyer miles attributable to business travel. Not surprisingly, in its initial guidance regarding frequent flyer miles in a business context, (6) the IRS ruled that frequent flyer awards earned on business trips should be treated as taxable income. Critical commentary followed the issuance of this guidance, and seven years later, while not conceding that frequent flyer miles are not income, the IRS issued Announcement 2002-18, (7) which stated that it would not impose understatement liabilities on taxpayers on account of the receipt or personal use of frequent flyer miles or other in-kind promotional incentive attributable to a taxpayer's business or official travel.

In issuing this moratorium on the taxation of frequent flyer miles, the IRS acknowledged the "numerous technical and administrative issues relating to these benefits on which no official guidance has been provided, including issues relating to the timing and valuation of income inclusions and the basis for identifying personal use benefits attributable to business (or official) expenditures versus those attributable to personal expenditures." The IRS did state, however, that this moratorium is to be narrowly construed and does not apply to travel or other promotional benefits that are converted to cash, compensation that is paid in the form of travel or other promotional benefits, or other circumstances where these benefits are used for tax avoidance purposes.

As provided in Rev. Proc. 89-14, (8) published revenue rulings do not have the force and effect of IRS regulations. In *Mead Corp.*, (9) the Supreme Court held that an administrative

agency's interpretation of a statute contained in an informal rulemaking must be accorded the level of deference set forth in *Skidmore v. Swift & Co.* (10) In the *Skidmore* case, the Court held that the deference required depends on the "thoroughness evident in [the agency's] consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it the power to persuade." Although the ruling addressed in *Mead* was a Customs Service tariff ruling, in *Omohundro*, (11) the Ninth Circuit held that it was appropriate to apply the *Mead* standard of review to revenue rulings.

Observation: If the issue of how to tax points awarded under an employee award program were to be presented to a court, based on the *Jack* analysis in Rev. Rul. 70-331, under the *Mead* standard the court likely would have the authority to disregard this ruling in making its decision.

Timing Sec. 83

At first blush, it might appear that employee reward programs should be taxable under the Sec. 83 rules governing the transfer of property in connection with the performance of services. As defined under Regs. Sec. 1.83-3(e), however, the term "property" includes only stock, real property, and personal property other than money or an unfunded and unsecured promise to pay money in the future. It is important to note that employee reward programs generally are not funded--that is, employers do not contribute cash to an "employee award trust" at the time points are granted to employees so that funds can be accumulated to satisfy the obligation when the employee later redeems the points; rather, the employer purchases the prizes only after the employee selects the merchandise for which the points are to be redeemed. Thus, until such time as they are redeemed for prizes, the points would appear to constitute an unfunded and unsecured future promise by the employer to pay, so points awarded under an employee reward program may not be taxable under the rules of Sec. 83.

Cash Equivalency Doctrine

The cash equivalency doctrine essentially provides that if a promise to pay a benefit to an individual, even though unfunded, is unconditional and exchangeable for cash, the promise is the equivalent of cash and is currently taxable. The most succinct description of the cash equivalency theory is found in *Cowden*, (12) where the Fifth Circuit held that deferred bonus payments (which were assignable and in fact were assigned for their discounted value to a bank) were taxable in the year in which the agreement that gave rise to the payments was executed, not in the later year in which the payments were made. The court based its conclusion on what has become the classic definition of the cash equivalency doctrine:

A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a solvent obligor is unconditional and

assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation. The principle that negotiability is not the test of taxability in an equivalent of cash case such as is before us, is consistent with the rule that men may, if they can, so order their affairs as to minimize taxes, and points up the doctrine that substance and not form should control in the application of income tax laws. (15)

It seems clear that the points issued under most employee reward programs would not be considered a cash equivalent under the Cowden standard. Years after the Cowden decision, however, Treasury issued Regs. Sec. 1.61-2(d)(4), which generally provides that a taxpayer receiving as compensation for services a note or other evidence of indebtedness has income equal to the FMV of the note at the time of its transfer. It could be argued that Regs. Sec. 1.61-2(d)(4) taxes a service provider upon receipt of a note or other evidence of indebtedness from his or her employer for services, regardless of whether the note rises to the level of a cash equivalency under the Cowden test and even though it is unfunded and unsecured.

Unfortunately, the potential conflict between Regs. Sec. 1.61-2(d)(4) and Cowden remains unreconciled. Therefore, to reduce the risk that the points issued under a reward program will be held as an "other evidence of indebtedness," and hence taxable when awarded under the cash equivalency doctrine, employers should consider including language in their programs that prohibits participants from assigning, alienating, pledging, encumbering, or otherwise transferring their interest in the plan and should include spendthrift provisions precluding its attachment by the participant's creditors.

Constructive Receipt

In general: Even if the points issued under an employee reward program are not cash equivalents, it is possible that they could nonetheless be taxable under the related doctrine of constructive receipt. Sec. 451 and the regulations there-under generally require a taxpayer to recognize income in the tax year in which the taxpayer receives it under his or her method of accounting. As explained in Regs. Sec. 1.451-2(a), even under the cash receipts and disbursements method, a taxpayer may recognize income prior to the actual receipt of cash:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Rev. Rul. 60-31, however, indicates that the doctrine of constructive receipt is to be determined upon the basis of the specific factual situation involved and sparingly applied.

Rev. Rul. 60-31 refers to the case of Gullett, (14) in which the Board of Tax Appeals, citing a number of authorities for its holding, stated:

It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice. (15)

The applicability of the constructive receipt doctrine to an employee reward program of course will depend on the terms of the plan. In most instances, the employee reward program will permit employees to select the merchandise for which they will redeem the points accumulated under the plan.

Example 1: Company Y has an employee reward program with a minimum prize level of 5,000 points. At this level, an employee can choose among a variety of \$50 gift cards. The incentive prize catalog also contains a variety of prizes at different point levels, up to a \$70,000 automobile that requires 1 million points. Employee X is awarded 5,000 points. However, he chooses not to redeem the points because he is saving them for a cruise at the 50,000 point prize level that costs \$1,500. But because X has accumulated enough points to redeem the minimum merchandise reward, the IRS might argue that the doctrine of constructive receipt would require X to recognize \$50 of income.

It should be noted in this example not only that employees can earn larger prizes by accumulating points, but also that the redemption equivalent value of each point increases as the total number of points accumulated increases. For example, at the 5,000-point level, each point has a redemption equivalent value of \$.01. At the 50,000-point level, each point has a redemption equivalent value of \$.03. At the 1-million-point level (maximum), each point has a redemption equivalent value of \$.07. Once an employee has accumulated enough points to redeem merchandise at the minimum prize level, he or she has an ongoing right to elect to receive merchandise at any time; nonetheless, the constructive receipt doctrine generally should not be applied to tax employees as points are initially granted under the plan.

First, an argument can be made that until an employee actually redeems points for merchandise, he or she has not accepted them. Second, the IRS has conceded in the context of stock appreciation rights (SARs) that it is possible for taxpayers to avoid constructive receipt, even when they have an ongoing right to elect withdrawals at any time. (16)

Refusal to accept: In Rev. Rul. 57-374, (17) the IRS held that "[w]here an individual refuses to accept an all-expense paid vacation trip he won as a prize in a contest, the fair market value of the trip is not includible in his gross income for federal income tax purposes." There are a variety of reasons why a recipient might choose not to accept a prize (i.e., prize was not to the recipient's liking, recipient could not afford to pay the taxes on the income attributable to the prize, etc.). In the case of an employee reward program, employees who want to accumulate enough points for a big-ticket item must refuse to exchange their

points for a small-ticket item. Just as it would be unfair to tax game show contestants on what is behind door number one even though they selected door number two, it would also be unfair to tax employees on the value of a small-ticket item that they have refused to accept.

Whether the acceptance argument would be sufficient to avoid constructive receipt once again may depend on the specifics of the employee reward program--perhaps even on the specific identity of the gift cards offered under the program. To strengthen the argument against constructive receipt, reward programs should avoid including general purpose gift cards (e.g., Visa, American Express, etc.) as base awards because such awards would likely be held to be cash equivalents. In the case of American Airlines Inc., (18) the Court of Federal Claims (affirmed on this issue by the Federal Circuit) found that American Express vouchers issued by an airline to its employees were cash equivalents. The vouchers were freely transferable, were subject to virtually no restrictions, and could be used at any restaurants accepting American Express cards. If, on the other hand, base awards under an employee reward program are limited to gift cards to local restaurants or retail establishments that cannot be readily converted to cash because of the lack of a secondary exchange market, and the employee has little or no desire to patronize the establishments for which the gifts cards are offered, the argument that the gift cards are not cash equivalents and that constructive receipt therefore should not apply is much stronger.

Stock appreciation rights: A SAR is an award that provides an employee with the ability to profit from the increase in value of a set number of shares of company stock over a set period of time. Like stock options, employees generally have flexibility about when they choose to exercise the SAR; however, unlike a stock option (where the employee is required to pay an exercise price to acquire stock), the employee is not required to pay to exercise a SAR. Until the SAR is exercised, there generally is no constructive receipt of income, even if the underlying stock has appreciated in value. In Rev. Rul. 80-300, the IRS recognized that because an employee cannot access the current value of the appreciation in the employer's Stock without giving up the right to benefit from further appreciation, there is a substantial limitation on the employee's ability to gain the value so the employee is not considered to be in constructive receipt of the income attributable to the current appreciation.

[ILLUSTRATION OMITTED]

In certain situations, however, the IRS has applied the constructive receipt doctrine to tax unexercised SARs. In Letter Ruling 8104119, (19) the IRS held that where the terms of a SAR place a ceiling on the amount an employee may receive on the exercise of the right, constructive receipt will occur in the year in which the ceiling is reached because the employee would not be at risk of substantial forfeiture of future income. The constructive receipt doctrine was also applied in Letter Ruling 8120103, (20) in which an employee who had failed to exercise a SAR before the end of the term (and had lost the right to any benefit) was held to have constructively received income equal to the payment he could have received if he had exercised the SAR immediately before it expired.

Whether the rationale of Letter Rulings 8104119 and 8120103 should be applied to employee reward programs again depends on the terms of the program. Where a program provides for increasing redemption equivalent values and a variety of high-ticket items, very few employees would be expected to reach the program's "ceiling." Constructive receipt may be likely to arise, however, if an employee reward program permits employees to exercise points following termination. Upon termination, employees will not be awarded any additional points, and thus their redemption equivalent value will not increase, nor will they be able to accumulate additional points to redeem awards at a higher prize level. In both cases (e.g., attainment of a ceiling or termination), an argument could be made that the employee reward program should be distinguished from the SAR plans in Letter Rulings 8104119 and 8120103.

In the SAR plans, the payment that the employees would have received had they exercised the SAR was cash; thus, the failure to exercise the SARs was arguably the same as the failure to cash a paycheck that had been made available to the employees. In the case of an employee reward program, on the other hand, as long as the prize awards contained in the incentive catalog are not cash equivalents, employees arguably should have the right to refuse the prize awards by failing to redeem their points.

The IRS acknowledged a taxpayer's right to refuse a prize award in Letter Ruling 6304054840A. (21) In the facts of the letter ruling, a taxpayer won a trip in 1962 but did not expect to take the trip until 1963. The IRS required the taxpayer to include the FMV of the trip in income when it was awarded in 1962 but stated that if the taxpayer refused the trip in 1963, he could file an amended 1962 return indicating he had refused the gift and eliminating it from gross income in 1962. If the logic of this letter ruling were to be applied to an employee reward program, constructive receipt would seem to require the employee to recognize income when a ceiling is reached or when termination occurs until such time as the outstanding points under the reward program expire unredeemed, either by the employee's affirmative election to refuse to redeem the points or by the employee's failure to redeem the points before they expire in accordance with the terms of the program.

Valuation

The valuation issues associated with employee award programs may depend not only on which Code section is used to determine value but also on whether the item being valued is the points that are awarded under the program or the prizes for which points are later redeemed, Secs. 61 and 74 and the regulations thereunder both contain rules that might apply when an employer transfers a noncash prize to an employee. Regs. Sec. 1.61-2 provides that if property is transferred by an employer to an employee as compensation for services for an amount less than its FMV, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its FMV at the time of the transfer is compensation and is included in the gross income of the employee. Similarly, Sec. 74 and the regulations thereunder provide that if a prize or award is made not in money but in goods or services, the amount to be included in income is the FMV of the goods or services.

Although neither Sec. 61 nor Sec. 74 contains a general definition of the term "fair market value," Regs. Sec. 1.61-21, which applies to fringe benefits provided by an employer to an employee, defines the term as "the amount that an individual would have to pay for the particular fringe benefit in an arm's length transaction." The regulation specifically states that an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit's FMV, nor is the cost incurred by the employer determinative of its FMV. The term "fringe benefit" is not defined in the Code or in IRS regulations, but Regs. Sec. 1.61-21 contains examples of fringe benefits, and several of them (e.g., employer-provided benefits such as an automobile, a free or discounted commercial airline flight, a vacation, a discount on property or services, or a ticket to an entertainment or sporting event) are items that might be included as awards in the incentive catalog of an employee reward program.

The arm's-length standard of Regs. Sec. 1.61-21 is inconsistent with the holding of the Turner case, (22) which the Tax Court decided under Sec. 74. In Turner, the Tax Court gave weight to subjective factors in determining the value of prizes and awards to specific taxpayers. In the facts of this case, the taxpayer had received two first-class, round-trip tickets to Buenos Aires as a promotional award from a radio station. The IRS asserted that the value of the tickets was their \$2,200 retail value. The taxpayer negotiated with an agent of the steamship company to surrender the two first-class tickets in exchange for four round-trip tourist steamship tickets between New York City and Rio de Janeiro. Noting that the tickets were not transferable or salable and that there were other restrictions on their use, the Tax Court concluded that the tickets did not provide the taxpayers "with something which they needed in the ordinary course of their lives and for which they would have made an expenditure" and used its discretion to reduce the value of the tickets to \$1,400 (a 36% discount).

Based on the Turner case, it would appear possible that under Sec. 74, subjective considerations could be taken into account in determining the FMV of a prize award; however, the courts have addressed valuation issues similar to those under Sec. 74 in Sec. 61 and, in doing so, have emphasized objective factors in determining the amount to be included in the taxpayer's income upon the receipt of property other than cash. In Rooney, (23) which involved accountants who, on an ad hoc basis, agreed to accept goods and services in payment of delinquent accounts, the Tax Court ruled that an objective standard should be used in valuing goods and services received by the taxpayer. The court stated that

section 61 requires an objective measure of fair market value. Under such standard, [taxpayers] may not adjust the acknowledged retail price of the goods and services received merely because they decide among themselves that such goods and services were overpriced. (24)

The Ninth Circuit also upheld an objective standard in Koons. (25) In that case, an employee received taxable household moving services in partial payment for accepting employment at a new location. The IRS asserted that the value of the moving expenses was the amount the employer had paid for them, while the taxpayer argued that the moving

expenses had no value to him. The Ninth Circuit rejected the taxpayer's argument that the amount of income charged to the employee for the moving services should be measured on the basis of a subjective valuation of them by the taxpayer, stating that the use of a subjective measure of value

would make the administration of the tax laws in this area depend upon a knowledge by the Commissioner of the state of mind of the individual taxpayer ... [and] that sound administration of the tax laws requires that there be as nearly objective a measure of the value of services that are includible in income as possible, and the only such objective measure that has been suggested to us, or that occurs to us, is fair market value. (26)

The Koons court noted that the taxpayer has the burden of overcoming the presumption of correctness afforded the IRS and that the taxpayer did not present any evidence that the amounts paid by the employer to the moving companies was greater than the FMV of these services. It is immaterial that the taxpayer could have arranged for moving at less cost, or even for nothing. The court criticized the taxpayer for voluntarily accepting the service and then asserting, after the fact, that the services were of little or no value to him.

Even if it was determined that employee reward programs were not fringe benefits subject to Regs. Sec. 1.61-21, it would seem unlikely that the Turner case could be argued to support a subjective discount, because in that case the prize was predetermined, while in the case of most employee reward programs, employees have the ability to select the merchandise for which their points will be redeemed. Therefore, regardless of whether the prize awards constitute fringe benefits, the arm's-length standard of Regs. Sec. 1.61-21 seems like an appropriate standard to use to address the valuation issues associated with employee reward programs.

The McCoy case, (27) also decided under Sec. 74, raises the interesting question of whether property purchased by an employer and subsequently awarded to an employee should be valued as new or used property. In the facts of the case, the IRS asserted that the FMV of a car a taxpayer received from his employer as a sales contest award was equal to the employer's cost to purchase the car (\$4,453). The Tax Court disagreed, however, and found that the property to be valued was not the property purchased by the employer but rather the property received by the employee, stating that it is "common knowledge" that "when an automobile has been purchased from a dealer the purchaser cannot, on a sale of the car, normally realize the price which he paid for the car, even though it has not been actually used." In the case of an employee reward program where the employer purchases and receives the high-end prize awards and then presents them to the employee-recipients as part of an award ceremony, it is possible, even under the arm's-length standard of Regs. Sec. 1.61-21, that property awarded could and should be valued as used property under the logic of the McCoy case. Regs. Sec. 1.61-21 specifically states that the cost incurred by the employer is not determinative of FMV.

If the IRS and the courts struggle to value merchandise, one can only imagine the practical difficulties in valuing points that an employee may redeem for merchandise. Assuming that the points are unique to the employer award program and the employee may not transfer

them, they have value only in the context of the program under which they are awarded. Since these points cannot be acquired in an arm's-length transaction, it would not seem possible to value them using the arm's-length standard of Regs. Sec. 1.61-21.

Valuing points outside the arm's-length standard would appear equally impossible. Because the award of one point could have a potentially different value depending on the number of unredeemed points accumulated by the employee to whom the point is awarded, there are many practical issues associated with assigning a value to points. First, there is the issue of how to treat points that an employee may not redeem immediately after they are issued. For example, if the employee receives an award of 50 points when the minimum award level is 5,000 points, what is the value of the 50 points? Until the employee earns an additional 4,950 points, arguably the value of the first 50 points is zero. Then there is the issue of how to value points when the redemption equivalent value of points increases as the employee accumulates the points. It would seem unfair to tax employees who earn minimal points at the highest possible redemption equivalent value. But if a lower redemption equivalent value were assigned to points that were accumulated and later redeemed for a higher redemption equivalent value, such employees would arguably be required to recognize income or a gain upon redemption. This does not seem practical. Finally, there is a possibility that points may expire unused. If employees are taxed on the points when they are credited to their accounts, would there be a deductible loss if the points expire unused? For these reasons, it would appear that the FMV of the points cannot be determined until they are actually exchanged for the desired merchandise.

Sec. 409A

The enactment of Sec. 409A by Congress as part of the American Jobs Creation Act of 20042 (28) further complicates the taxation of point-based employee reward programs. Sec. 409A imposes timing restrictions on nonqualified deferred compensation (NQDC). Under the Sec. 409A regulations, a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a tax year to compensation that, under the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later tax year.

Failure to comply with the Sec. 409A requirements will result in all vested compensation deferred under the plan being includible in the employees' gross income. In addition, the affected employees will be subject to a 20% additional income tax on the amounts required to be included in income, as well as a premium interest tax, which is designed to collect interest from employees on income taxes they would have paid in prior tax years if the amounts required to be included in income had not been deferred.

Employee reward programs can attempt to avoid the imposition of the Sec. 409A penalties either by structuring the program so that it does not meet the definition of NQDC (and therefore is not subject to the Sec. 409A restrictions) or by complying with the Sec. 409A restrictions.

Although many employee reward programs will issue points in one year that employees will not redeem until a later year, whether the issuance of points constitutes compensation seems arguable. Again, the issue of valuation may come into play. If, until such time as the employee redeems points for merchandise of his or her choosing, the employee has not received anything of value, can there be a deferral of compensation?

The Sec. 409A regulations provide that NQDC does not exist unless the service provider has a legally binding right to compensation and that Sec. 409A does not apply when compensation can be reduced unilaterally or eliminated by the employer after the services creating the right to the compensation have been performed. (29) Thus, if an employee reward program provides that the employer has the unilateral right to terminate the program at any time, it is possible that Sec. 409A should not apply to the program. It should be noted, however, that the Sec. 409A regulations provide that if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks substantive significance, Sec. 409A will apply.

Where an employee has a legally binding right to compensation, the requirements of Sec. 409A can still be avoided under the short-term deferral exception. (30) Under that exception, Sec. 409A generally does not apply to compensation that is payable no later than the 15th day of the third month of the first tax year in which the amount is no longer subject to a substantial risk of forfeiture. The regulations provide that a substantial risk of forfeiture exists if the rights to compensation are conditioned upon the future performance of substantial services by any individual.

Example 2: Assume the same facts as in Example 1. If employee X, upon becoming eligible to participate in the reward program, were required to make an irrevocable election to designate the prize award for which he would redeem the points he accumulated under the plan, and if redemption occurred automatically as soon as X had accumulated the necessary points, the reward program would presumably qualify for the short-term deferral exemption. Until such time as X has earned enough points to redeem the designated prize award, his right to the prize award is arguably subject to a substantial risk of forfeiture because he must perform future services before he has a vested interest in the prize award.

Alternatively, it might be possible to structure an award program that complies with the Sec. 409A requirements by requiring employees to make an election to designate the time at which accumulated points will be redeemed. Under Sec. 409A, the permissible distribution events may include:

- * Separation from service;
- * Disability;
- * Death;
- * A time specified under the plan at the date of deferral;

* A change in control or ownership of a substantial portion of the assets of the service recipient; or

* The occurrence of an unforeseeable emergency.

The time and form of distribution must be specified at the time of deferral and generally cannot be altered; however, an employee can elect to change a deferral election as long as the change is made at least 12 months before the originally scheduled payment was to have occurred and the change defers the payment for at least five years.

Under this scenario, rather than making an irrevocable election as to which prize award his points would be redeemed for, upon becoming eligible to participate in the reward program X would be required to complete an application specifying the time at which the points he accumulates under the reward program will be redeemed. For example, X might elect to redeem his points in year 5 or, if earlier, upon separation from service, death, disability, or change in control. When the permissible distribution event occurs, X must redeem his accumulated points at that time; however, he will be free to select from the available prize awards in the incentive catalog.

Example 3: By the end of the fourth year of participating in the program, X has accumulated 20,000 points. X would like to redeem his points for a cruise at the 50,000 point level and does not anticipate that he will earn 30,000 points by the end of year 5. No later than the end of year 4, X could make a re-deferral election to delay redeeming his points until sometime after the end of year 10. Although the five-year minimum re-deferral period would presumably be a significant deterrent to most employees, it does offer some flexibility to employees desiring to redeem points for big-ticket items.

Withholding

Sec. 3401(a) provides that for income tax withholding purposes, "wages" means all remuneration for services performed by an employee for his or her employer. Sec. 3121(a) defines the term for FICA purposes as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash (with certain specific exceptions not here applicable). Thus, once the employer has determined the time and amount of taxable compensation, it is required to withhold taxes on such compensation. In most instances, employers will withhold the taxes attributable to the prize awards by reducing the employee's cash compensation. This reduction in take-home pay can be problematic for many employees, particularly when the amount of the noncash reward is significant.

The IRS has issued withholding and reporting guidelines for taxable noncash fringe benefits that give employers significant flexibility in determining when the value of noncash fringe benefits should be included in income and subject to withholding. Announcement 85-113 (31) permits employers to elect, for employment tax and withholding purposes, to treat fringe benefits as paid on a pay period, quarterly,

semiannual, annual, or other basis, provided the benefits are treated as paid no less frequently than annually. Employers do not have to make the same election for all employees. Therefore, the employer may withhold more frequently for some employees than for others. Employers may change their election as frequently as they desire as long as they treat all the benefits provided in a calendar year as paid no later than December 31 of the calendar year. For example, an employer may treat benefits provided in a calendar year as paid on July 31, August 31, and December 31 of the calendar year.

An employer may treat the value of a single fringe benefit as paid on one or more dates within the same calendar year, even if the employee receives the entire benefit at one time. For example, if the employee receives a fringe benefit valued at \$1,000 in one pay period, the employer may treat the \$1,000 fringe benefit as made in four payments of \$250, each in a different pay period, rather than as a \$1,000 payment in one pay period.

A formal election of payment dates is not required, and the IRS need not be notified; rather, employers are treated as making the election or elections simply by treating the fringe benefits provided in a calendar year as paid on the date or dates the employer chooses, but no later than December 31 of the calendar year in which the benefits are provided.

By giving employees the option to spread the withholding attributable to the redemption of a prize award over several pay periods or, alternatively, permitting employees to include the value of a noncash prize award in income at the time the employee receives a cash bonus, employers can help alleviate some of the negative cashflow issues caused by withholding on noncash fringe benefits.

Conclusion

Employee reward programs modeled on the affinity programs used by airlines and credit card companies can offer employers an efficient and effective way to incentivize employees. To enable employers to determine with certainty the amount and timing of the compensation earned under the program, and to encourage compliance, the IRS should revisit the issue and should issue practical guidance that employers can rely on in administering these plans.

Given the valid business purpose of such plans, it is possible that the IRS would achieve effective, efficient, and equitable tax administration if (except in the case of tax avoidance) it would permit plans to be taxed under the following guidelines:

- * Compensation generally should not be recognized by cash-basis employees until points are redeemed for prize awards; and

- * The cost the employer paid to acquire the award from an unrelated third party should be deemed to be the amount that the employee would have paid to acquire the award in an arm's-length transaction.

Until such time as the IRS issues additional guidance, however, employers must face the difficult task of addressing the timing and valuation issues associated with their plans on their own. Employers who are implementing new reward programs should pay careful attention to the specific terms of their programs in an effort to ensure the most favorable tax consequences for the plan, and employers who have existing plans should evaluate how they are reporting the income tax consequences of the plan to their employees to determine if it is appropriate.

Employers should also assess whether their plan is subject to or exempt from the Sec. 409A requirements and should consider having their programs reviewed by an ERISA attorney. In Notice 2010-6, (32) the IRS introduced a voluntary correction program that can be used when a deferred compensation plan's written document fails to comply with the specified written plan requirements under Sec. 409A. If an ERISA attorney determines that a Sec. 409A violation exists and if the requirements of the IRS programs are satisfied, it may be possible to avoid some (if not all) of the harsh penalties that otherwise apply when a plan does not meet the Sec. 409A requirements.

EXECUTIVE SUMMARY

* The use of point-based employee recognition programs has increased rapidly in recent years, but the employment and income tax treatment of awards received by employees through these programs remains unsettled.

* Income could be considered recognized at the time points are awarded under either the cash equivalency or constructive receipt doctrines; whether either doctrine applies to a particular plan depends on the terms of that plan.

* Existing statutory and regulatory law indicates that the amount of income recognized by an employee should be based on the fair market value of either the points awarded to the employee or the prizes he or she receives.

* The Sec. 409A rules for nonqualified deferred compensation plans could apply to point-based recognition plans, depending on the details of the plans.

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(4) Rev. Rul. 68-365, 1968-2 C.B. 418.

- (5) Rev. Rul. 70-331, 1970-1 C.B. 14.
- (6) Technical Advice Memorandum (TAM) 9547001 (11/24/95).
- (7) Announcement 2002-18, 2002-1 C.B. 621.
- (8) Rev. Proc. 89-14, 1989-1 C.B. 814.
- (9) Mead Corp., 533 U.S. 218 (2001).
- (10) Skidmore v. Swift & Co., 323 U.S. 134 (1944).
- (11) Omohundro, 300 F.3d 1065 (9th Cir. 2002).
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- (13) Cowden, 289 F.2d at 24 (footnotes omitted).
- (14) Gullett, 31 B.T.A. 1067 (1935).
- (15) Id. at 1069.
- (16) Rev. Rul. 80-300, 1980-2 C.B. 165.
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- (18) American Airlines Inc., 40 Fed. Cl. 712 (Fed. Cl. 1998), aff'd on this issue, 204 F.3d 1103 (Fed. Cir. 2000).
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- (22) Turner, T.C. Memo. 1954-38.
- (23) Rooney, 88 T.C. 523 (1987).
- (24) Id. at 528.
- (25) Koons, 315 F.2d 542 (9th Cir. 1963).
- (26) Id. at 545.

(27) McCoy, 38 T.C. 841 (1962).

(28) American Jobs Creation Act of 2004, P.L. 108-357.

(29) Regs. Sec. 1.409A-1(b)(1).

(30) Regs. Sec. 1.409A-1(b)(4).

(31) Announcement 85-113, 1985-31 I.R.B.31.

(32) Notice 2010-6, 2010-3 I.R.B. 275.

EditorNotes

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