

Year-End Bonuses, Gifts, Prizes, and Awards

What's Taxable? What's Not?

Must you withhold income and Social Security taxes on a \$500 bonus? (Yes)

Is there a difference in the way a holiday bonus, production bonus and Christmas turkey are taxed? (Yes)

Are safety and length-of-service awards taxable? (Not necessarily)

Are gift certificates taxable? (Some are, some are not)

No need to call your CPA—you can save your company and your employees on taxes by following a few simple rules.

Generally, cash and gifts or prizes convertible to cash—for example, gift certificates—must be included in the employee's gross income and are subject to withholding. However, cash or the equivalent, up to \$25 generally is considered *de minimis* (of minimal value) and not taxable.

Cash bonuses

Cash bonuses are wages and are subject to all federal, state and local withholding taxes and *must* be included on the employee's W-2. If the bonus is paid separately from regular wages, or paid with regular wages but identified as separate, it may be treated as supplemental wages with federal income tax withheld at a flat 28% and other taxes withheld at their regular rates.

Bonuses and overtime pay

There are two kinds of cash bonuses: *discretionary* and *nondiscretionary*:

Discretionary bonuses are lump-sum payments that the employer decides *whether* to give, *when* to give

and *how much* to give. These bonuses are called “discretionary” because they are not required under a contract, agreement or promise and are not part of a pattern that has lead employees to expect them. In other words, to qualify as discretionary, the bonus must be *a complete surprise to the employee*.

Holiday bonuses are an exception. Even when given each year—leading employees to expect them—holiday bonuses can be treated as discretionary bonuses. This is important because a discretionary bonus for hourly employees does not affect their overtime pay rate.

Nondiscretionary bonuses. These are bonuses required under a contract, agreement or promise. Typically, nondiscretionary bonuses are given for faster or higher production, improved quality, to induce someone to take a job or stay on, or are bonuses that employees have come to expect (with the exception of holiday bonuses). A nondiscretionary bonus given to hourly employees must be added to gross pay for the week in which it is earned and included when calculating their pay for overtime purposes.

Prizes and awards

Prizes and awards must be included in wages and are subject to all taxes. But there are exceptions. The exceptions: Generally, prizes and awards for efficiency, production, attendance, quality, or other work-related achievements are included when calculating overtime pay, as in the example above. If the bonus is merchandise, the actual cost (not the list price) is used in the computation of overtime pay.

Achievement awards

Achievement awards are not taxable to the employee—if the employer can deduct the cost of the award. To be deductible, the awards cannot favor highly paid employees, must be given in some kind of ceremony and must be “tangible personal property”—not cash or cash equivalents, such as stocks, bonds, meals, lodging or sports or theater tickets. There are annual per-employee limits based on the kind of plan under which the awards are given.

Length-of-service awards cannot be given before 5 years of service and no more frequently than every 5 years.

Safety awards cannot be given to management, administrators or professional, clerical or part-time employees. The awards must be limited to less than 10% of eligible employees during the taxable year. If it turns out that, say, 12% of employees qualify, it cannot be given and retain its tax-free status.

Suggestion awards

Suggestion awards generally need not be included in an employee's hourly pay rate (which affects their overtime pay). But to be nontaxable, the suggestion must be voluntary, cannot be part of the employee's job and cannot be a device to siphon off tax-free pay to the employee.

Noncash prizes

Include the fair-market value on the employee's W-2.

Cash prizes for retail commission salespeople. If you ordinarily pay employees only cash commissions and there is a cash prize for services performed, then the employer has the

option of not withholding taxes on a cash prize for retail commission salespeople.

Gifts. Turkeys, hams, champagne, flowers, fruit baskets, etc. generally are not taxable to employees as a *de minimis* fringe benefit. Similarly, a gift certificate that can be used only for a designated item at a designated store and cannot be converted to cash is not taxable to employees. However, gift certificates for items convertible to cash and department store and general merchandise gift certificates are fully taxable to employees.

For example, say that at Thanksgiving you give each employee a gift certificate redeemable only for a turkey at a specific store. Because employees cannot convert the gift certificate to cash (the certificate is redeemable only for a turkey), the gift is nontaxable. But if you give employees a \$50 gift certificate to the same store, redeemable for merchandise and the balance in cash, the \$50 must be included in the employee's income and subject to all taxes.

Parties and picnics

The IRS considers the cost of parties to be nontaxable to employees and their families as a *de minimis* fringe benefit—if the parties are infrequent and for the purpose of promoting employee health, goodwill, contentment or efficiency. Examples include holiday celebrations, occasional cocktail parties and company picnics. ☺

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