Motivate Your Employees

and Make Your Workplace More Productive

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Employee Incentive Programs
Motivating Employees With Incentives, Prizes, and Awards

Motivating employees to perform their duties in the most efficient and effective way is a simple way to work towards maximizing the business's profits.

Consider employee incentive programs to encourage employee performance and loyalty, and to instill a commitment to the company.

There are a number of possible means by which a business may accomplish this, but in this paper we are going to focus on three of them:

1. **Cash and Non-cash Incentives**
2. **Prizes**
3. **Recognition Awards**

Do incentive programs really affect workplace performance?

A 2008 study sponsored by the International Society for Performance Improvement determined:

> "**Incentive programs can boost performance** by anywhere from 25 to 44%, but only if conducted in ways that address all issues related to performance and human motivation."

Harold D. Stolovitch, Richard E. Clark, and Steven J. Condly, **Incentives, Motivation & Workplace Performance: Research and Best Practices**, The Incentive Research Foundation, **2008**.

That study focused on the **"issues related to performance and human motivation"** and the positive impact that incentive programs can have on motivating employees to improve their performance and gain greater satisfaction in the workplace.

However, the purpose of this paper is to address the financial and tax impacts on both employers and employees that result from such programs.

What Is the Financial Impact of Employee Incentive Programs?

The cost of recognizing and motivating employees is usually a tax deductible expense for a business.

Any business that has a program for motivating employees has to find a balance between the cost of recognizing employee achievements and the potential for an increase in business income. If the amount of income that is generated as a result of such programs is greater than the cost of the program, then the business's profits will be greater.

One factor that affects that balance is whether or not the tax-deductible expense is in the form of wages or a simple business expense. If the expense is in the form of wages, then the employer will also incur additional costs in the form of social security, Medicare, and unemployment taxes, as well as workers compensation insurance. So it is to the employer's advantage if the cost of providing incentives is not treated as employee compensation. This can be achieved only if the cost of an incentive can be excluded from the employee's wages.

In the remainder of this paper we will, therefore, examine how different forms of incentives must be treated in order to determine their impact on both employers and employees.

Incentives

It is a common belief that a primary motivator for improved employee performance is money.

Incentive programs that can result in additional income in an employee's pocket can often increase job performance, but they do not necessarily instill employee loyalty. Non-cash incentives, on the other hand, may be used by some businesses to increase loyalty, especially when employees work as part of a team.

The primary characteristic of most incentive programs, whether cash or non-cash, is that they must be treated as employee wages or compensation.

As such, the amount of the cash incentive or the fair market value of a non-cash incentive is subject to income tax withholding, and it must be reported as income on the employee's Form W-2 at the end of the year.

Incentives may take several forms, including bonuses, prizes and awards, prize points for salespeople, etc. Each of these is discussed separately below.

Bonuses

Performance bonuses are often used by manufacturers to increase production by either individual employees or teams. Sales bonuses may be awarded when a salesperson or a sales team surpasses certain goals. The key point is that all bonuses are cash bonuses that are added to an employee's wages.

An important point to keep in mind is that incentive bonuses are defined by the IRS as non-discretionary bonuses. As such, they must be included in an employee's wages when calculating overtime.

For instance, if an employee earns a $500 bonus for exceeding his production goals over a 4-week period, then that $500 bonus must be divided by 4, and $125 allocated to each of the weeks during that 4-week period. If the employee worked overtime during any of those weeks, the employee's overtime pay must be recalculated for each of those weeks and the additional pay added to the employee's wages. (The article The Basics of Calculating Overtime Pay, written for payroll professionals, provides more details.)

Bonuses are supplemental wages, so they must be added to the employee's paycheck, and they are subject to tax withholding according to the supplemental wage withholding rules.

Prizes and Awards

At times employers may choose to reward employees for their performance, or as a reward for individuals or teams that meet certain goals. Such awards or prizes are always taxable income to the employee unless they are specifically excluded by law. For instance, the following awards and prizes must be included in an employee's wages:

1. Cash awards or prizes.
2. Cash equivalent awards, such as savings bonds or gift certificates.
3. Non-cash recognition awards for job performance, unless the award qualifies as a de minimus fringe benefit.
4. Non-cash prizes won by employees from random drawings at employer-sponsored events.
5. Awards for performance, such as outstanding customer service, employee of the month, or highest productivity.

Since the purpose of most awards or prizes is to motivate employees, many employers may feel that requiring an employee to pay taxes on an award or prize is counterproductive. In such cases, the employer may choose to pay the employee's share of the taxes. However, any taxes paid on behalf of the employee become taxable income as well. The correct procedure for calculating such taxes is outlined on page 22 of IRS Publication 15-A, **Employer's Supplemental Tax Guide**.

Prize Points or Prizes from a Third Party

Distributors or manufacturers may try to motivate their dealers' salespeople to sell their products by awarding them with prize points. These prize points are redeemable for merchandise. The fair market value of these points must be included in a salesperson's income. The prize points are taxable in the year in which they are paid or made available to the person, rather than in the year the person redeems them for merchandise.

Other distributors or manufacturers may have incentive programs for salespeople who sell their products. These may be either cash or non-cash awards or prizes, and they are taxable in the year in which the payment is made by the third party.

The issues that must be addressed here is how the income is to be reported and whether or not income taxes must be withheld on the fair market value of the prize. If the prize points are given to the salesperson's employer to award or distribute, then the employer must withhold all necessary income taxes on the fair market value of the points, and the income and taxes must be reported on the employee's Form W-2.

On the other hand, if the distributor or manufacturer selects and distributes the points directly to the salesperson without any direction or decision-making from the salesperson's employer, then the distributor or manufacturer must report the income in Box 3, Other Income, of Form 1099-MISC. However, the value must be reported on Form 1099-MISC only if the total awarded to the person during the year has a total of $600 or more.

Non-Cash Prizes for Retail Salespeople Paid on a Commission Basis

Some retailers pay their salespeople solely on a commission basis for products sold. At times they may offer incentives for salespeople who exceed quotas or for selling the most goods during a specific period of time. Such prizes receive special treatment. Although the fair market value of the prize must be included on Form W-2 as taxable income, employers are not required to withhold federal income taxes from such prizes. However, social security and Medicare taxes must be withheld, and the prize is still subject to the federal unemployment tax.

Awards That Can Be Excluded from an Employee's Taxable Income

As discussed above, most awards and prizes must be included in an employee's income. However, there are three types of employee awards that may be excluded from income under certain circumstances, so the cost or fair market value of these awards is a tax-deductible expense for the business:

1. De minimus awards and prizes.
2. Civic and charitable awards.
3. Employee achievement awards.

According to IRS Publication 5137, Fringe Benefit Guide, an award or prize may be treated as a de minimus award if it meets the following criteria:

1. It is not cash or a cash equivalent, such as a savings bond or gift certificate,
2. It has a nominal value, and
3. It is provided infrequently.

The word "**nominal**" is defined as meaning small in value, relative to the value of the employee's total compensation. There is no set dollar amount in the law for nominal awards, but the Office of Assistant Chief Counsel of the IRS advised in 2001 that an award with a fair market value of $100 did not qualify as a de minimus fringe benefit. However, a non-cash retirement award, such as a gold watch, is an exception to the rule and can be treated as a de minimus award.

Another example of a de minimus award is to provide the employee of the month with parking. The award is excludable from income only if the employee does not receive any cash, the value is less than the limit for qualified transportation fringe benefits as outlined in IRS Publication 15-B, Employer's Tax Guide to Fringe Benefits, and the individual employee does not receive the award on a frequent basis.

Certain civic and charitable awards can be excluded from income if the recipient transfers the award to a qualified charitable organization. To qualify for this kind of treatment the following requirements must be met:

1. The award is for civic, charitable, religious or educational achievement.
2. The recipient did not actively seek the award or enter any contest.
3. The award is not conditioned on performing any future services, even though the recipient may continue to be employed by the organization granting the award.
4. The recipient turns the award over to a qualified governmental or charitable organization, and the recipient has designated the organization before the recipient actually receives the award.

Employee Achievement Awards

According to IRS Publication 535, Business Expenses, an employee achievement award is "an item of tangible personal property" that meets all the following requirements:

1. It is given to an employee for length of service or safety achievement.
2. It is awarded as part of a meaningful presentation.
3. It is awarded under conditions and circumstances that do not create a significant likelihood of disguised pay.

What is "tangible personal property?" Unfortunately, the IRS doesn't include a definition in any of the publications that discuss employee achievement awards. Elsewhere in the Internal Revenue Code, tangible personal property is defined as personal property that is not real property (such as homes, buildings, land, etc.), and it is property that can be depreciated. (IRS **Publication 946**, How to Depreciate Property.) It does not include "intangible" property such as cash or cash equivalents, stocks, bonds, vacations, meals, lodging, or tickets to theater or sporting events.

The amount that can be excluded from an employee's income depends on whether or not the award is presented as part of a qualified plan. To be a qualified plan the plan must meet the following tests:

1. The plan must be written.
2. The plan cannot favor highly compensated employees. A highly compensated employee is defined in IRS Publication 535 as either being a 5% owner of the business at any time during the year, or an employee who received more than $115,000 in pay for the prior year.
3. The average cost of all employee achievement awards (including those that don't qualify for exclusion from employees' pay) during a single year does not exceed $400. Awards with a value of $50 or less are not included in the calculation.

The maximum amount of awards that can be excluded from pay for a single employee each calendar year is limited to:

1. $400 for awards that are not made under a qualified plan, or
2. $1,600 for all awards made during the year, whether or not they are awards made under a qualified plan.

Safety achievement awards can be excluded from income only if:

1. The employee receiving the award is not a manager, administrator, clerical employee, or other professional employee, and
2. The employee has worked full-time for a minimum of one year before the award is presented, and
3. Less than 10% of eligible employees have already received a safety achievement award during the year. If 10% of eligible employees have already received an award, then the entire fair market value of the award must be included in the employee's income.

Length-of-service achievement awards may be excluded from income only if:

1. The employee has been employed for more than 5 years, and
2. The employee has not received another length-of-service award during the same year or in any of the prior 4 years.

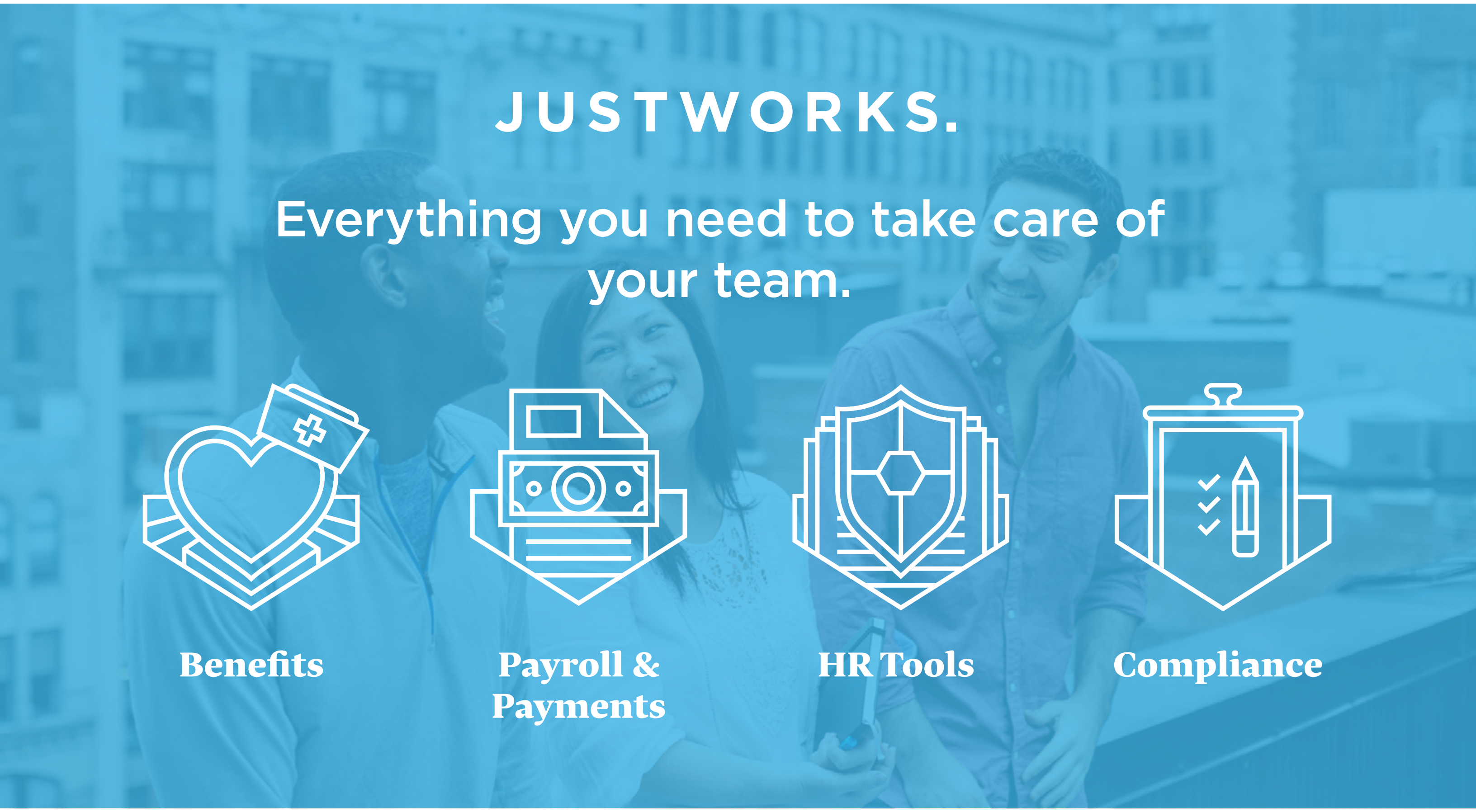
Retirement awards do not have to meet the 5-year rule in order to be excluded from income.

Conclusion

Employers that acknowledge and recognize the efforts of their employees can have an advantage in the economic marketplace.

This recognition may be achieved to some extent by means of employee incentive plans. Using cash and non-cash incentives, prizes and awards, employers may encourage loyalty among their employees and cultivate increased performance.

Properly managed incentive programs are a tax-deductible expense, either as a direct cost or in the form of employee compensation. Employers also have to recognize that along with increased wage costs come the cost of employer income taxes and insurance that are based on employee wages. But if properly balanced, employee incentive programs can positively affect a company's bottom line.



Schedule a free consultation today.

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