Giving Employees Gifts May Require Giving to the Tax Collector Too

By GJ Stillson MacDonnell and William Hays Weissman

The end of the year is a traditional time for employers to give gifts to their employees. While it is customary to think of gifts as having no tax consequences for the recipient, the Internal Revenue Code (Code) does not treat all gifts the same. Unfortunately, gifts that employers give to their employees are generally treated as supplemental wages, and thus subject to both payroll and income taxes. This means that the value of the gift must be included in the employee’s W-2 at year end and included in a payroll period for purposes of income tax withholding and payroll taxes.

General Rules Governing “Gifts”

The Code generally excludes gifts from the recipient’s gross income. Gifts are also excluded from payroll taxes. However, gifts employers give to their employees are not included within the Code’s exclusions from income and payroll taxes. Rather, they are generally treated as supplemental wages subject to tax.

In *Duberstein v. United States*, the United States Supreme Court explained that the term “gift” as used for income tax purposes differs from the common law understanding of the term. A “common law” gift is one made voluntarily and without any legal or moral obligation. In contrast, for a “gift” to be excluded from income and payroll taxes it must be made under a “detached and disinterested generosity,” or “out of affection, respect, admiration, charity or like impulses.” The most critical consideration is the transferor’s “intention.” The Supreme Court held intent is based on the reality of the situation and not the parties’ characterization of the item as a gift.

In the context of an employment relationship, the courts have generally found that the employer’s intention in giving a “gift” is as to reward for past performance or as an incentive for future performance. As such, the disinterested generosity standard set forth in *Duberstein* is not met. Thus, generally a gift an employer gives to its employees is treated as compensation for services, past or future, and falls within the definition of wages for income tax withholding and payroll tax purposes.
Major Exceptions to the General Rules Regarding Gifts

De minimis fringe benefits

De minimis fringe benefits that an employer gives to its employees are not subject to income or payroll taxes. A de minimis fringe benefit is any property or service the value of which (after taking into account the frequency with which similar fringes are provided by the employer to its employees) is so small as to make accounting for it unreasonable or administratively impracticable.

Examples of de minimis fringe benefits include occasional typing of personal letters by a company secretary; occasional personal use of an employer’s copying machine, provided that the employer exercises sufficient control and imposes significant restrictions on the personal use of the machine so that at least 85 percent of the use of the machine is for business purposes; occasional cocktail parties, group meals, or picnics for employees and their guests; traditional birthday or holiday gifts of property (not cash) with a low fair market value; occasional theater or sporting event tickets; coffee, doughnuts, and soft drinks; local telephone calls; and flowers, fruit, books, or similar property provided to employees under special circumstances (e.g., on account of illness, outstanding performance, or family crisis).

However, cash, no matter how small in amount, is never excludable as a de minimis fringe benefit because it is never administratively impractical to account for cash. This is true even if the cash is given so that the employee can obtain property that would be excludable as a de minimis fringe benefit. For example, giving cash to an employee for a theater ticket is not excludable as a de minimis fringe benefit, even if the ticket would have been excludable as a de minimis fringe benefit if the employer had provided the ticket itself to the employee.

Further, de minimis fringe benefits do not include items that have a cash equivalency. For example, if an employer gives its employees a gift coupon or gift certificate worth $35, even if only redeemable for a holiday turkey, that amount does not qualify as a de minimis fringe benefit and must be treated as wages.

Qualified Disaster Payments

Code section 139 provides that an employer may make payments to its employees that constitute “a qualified disaster relief payment” without any income or payroll tax consequences. “A qualified disaster relief payment” means any amount paid to or for the benefit of an individual to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a “qualified disaster,” or to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster. A “qualified disaster” is generally one that is declared by the President of the United States.

 Hurricanes Katrina, Rita and Wilma were all Presidentially declared “qualified disasters” within certain affected areas. Thus, employers may make payments to their employees to help them with living or personal expenses or repairing their homes without having to withhold or pay income and payroll taxes. This can be a very good way for employers to provide certain employees tax-free gifts this year.

Employee Achievement Awards

1. Employers may also provide “employee achievement awards” to their employees. The requirements are that the award:
   2. Be given for length of service or safety achievement.
   3. Be tangible personal property, other than cash, gift certificates or equivalent items.
   4. Be given under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.
   5. Be given as part of a meaningful presentation.
   6. Be no more than the specified dollar limits ($1,600 or $400 if not a qualified plan award).

However, the exclusion does not apply if the employee has received a length-of-service award for less than 5 years of service or within four years of a previous length-of-service award. In addition, the exclusion does not apply to a safety achievement award if the employee is a manager, administrator, clerical employee, or other professional employee, or if more than 10 percent of eligible employees previously received safety achievement awards during the year.
Planning Guidelines for Employers Giving Gifts to Employees

Employers should keep the following guidelines in mind when giving gifts to their employees this year:

- If an employer gives its employees a “gift” such as a turkey, ham, gift basket or other item of nominal value this holiday season, such gift will not be treated as either wages or income to the employee, and thus not subject to income or payroll taxes.

- Although “nominal value” is not defined anywhere, we recommend that to be safe employers should limit gifts to $25.00 in value, which is the limit on business expense deductions for gifts businesses give to their customers or clients. Higher amounts may be allowable, but could be subject to challenge.

- If an employer gives its employees a “gift certificate,” “gift coupon” or similar item with a face value, the face value must be included in the employee’s wages. Thus, if an employer gives a $25 gift card for the local shopping mall, the employer must include $25 in the employees wages, subject to income tax withholding and payroll taxes.

- If an employer gives its employees an item either redeemable for or easily exchangeable for cash, then the value of the gift is additional taxable wages regardless of the amount involved, and is subject to both payroll and income taxes.

- Employers may give cash payments to employees in certain areas affected by various disasters without tax consequences to pay for living and related personal expenses. Employers should be careful to comply with the provisions of the Code when making this kind of gift.

- If an employer contemplates giving a taxable gift to its employees, it should coordinate with its payroll department so that the amount of the gift can be included in the employees’ wages during a payroll period so that appropriate income and payroll taxes can be withheld. We therefore recommend that taxable gifts be given concurrent with or before the last payday of the year.

GJ Stillson MacDonnell is a Shareholder and chair of Littler Mendelson’s Employment Taxes Practice Group. William Hays Weissman is a Shareholder in Littler Mendelson’s Employment Taxes Practice Group. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Ms. MacDonnell at gjmacdonnell@littler.com, or Mr. Weissman at wweissman@littler.com.

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1 363 U.S. 278 (1960).
2 Id. at 285.
3 Id. at 286.
4 E.g., Foley v. Commissioner, 87 T.C. 605, 609 (1986)(“There is no gift where a payment is made in anticipation of future economic benefits.”).
5 In IRS Information Notice 2008-23 (June 27, 2008), the IRS indicated that a gift amount of $50 was used for administrative convenience. The IRS noted that there was no set dollar limit on de minimis fringe benefits. The $25 limit is a long-standing rule of thumb that comes from the limit for income tax deductions for gifts made by businesses, often for suppliers and customers. The Information letter did not actually endorse the $50 limit as an acceptable fringe benefit amount, and thus employers should be cautious about using an amount much higher than $25. Nonetheless, the Information notice is useful in reiterating that there is no bright line rule as to what amount constitutes a de minimis fringe benefit, and employer should use their best judgment when giving out gifts.