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Proposed Treasury Regulations  
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DEPARTMENT OF THE TREASURY  
Internal Revenue Service

26 CFR Part 1

54 FR 627; [IA-111-86]

**Income Tax; Taxable Years Beginning After December 31, 1986; Changes With Respect to Prizes and Awards and Employee Achievement Awards**

*Prop. Treas. Reg. Preamble 1-9-1989*

**DATE:** January 9, 1989

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed amendments to the regulations relating to the excludability of certain prizes and awards and to the deductibility of certain employee awards. Changes to the applicable tax law were made by the Tax Reform Act of 1986. These amendments, if adopted, will provide the public with the guidance needed to comply with the Act.

**DATES:** Written comments and requests for a public hearing must be delivered or mailed by March 10, 1989. The amendments are proposed to be effective after December 31, 1986.

**ADDRESSES:** Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224; Attention: CC:CORP:T:R, IA-111-86.

**FOR FURTHER INFORMATION CONTACT:** Johnnel St. Germain of the Office of Assistant Chief Counsel (Income Tax and Accounting), Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224; Attention: CC:CORP:T:R, IA-111-86. Telephone 202-566-4509 (not a toll-free call).

**SUPPLEMENTARY INFORMATION:**

**Paperwork Reduction Act**

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 ( 44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Information and Regulatory Affairs, Office

of Management and Budget, Washington, DC 20503, attention: Desk Officer for the Internal Revenue Service. Copies of comments should also be sent to the Internal Revenue Service at the address previously specified.

The collections of information in this regulation are in 26 *CFR* 1.74-1(c). This information is required by the Internal Revenue Service in order to verify that the proper amount of income is reported by taxpayers on their returns of tax. The likely respondents are individuals.

Estimated total annual reporting burden: 1,275 hours.

Estimated average annual burden per respondent: 15 minutes.

Estimated number of respondents: 5,100.

### **Background**

This document contains proposed amendments to the Income Tax Regulations (26 *CFR* Part 1) under *sections 74, 102, and 274 of the Internal Revenue Code* (Code). The amendments are proposed to conform the regulations to section 122 of the Tax Reform Act of 1986 ( Pub. L. 99-514). The proposed amendments, if adopted, will be issued under the authority contained in section 7805 of the Code (68A Stat. 917; 26 *U.S.C.* 7805).

### **General Information**

Prior to the 1986 Code, section 74 stated that prizes and awards, other than certain types of fellowship grants and scholarships, were includible in gross income unless they were made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. To qualify for the exclusion, the recipient must have been selected without any action on his part and could not be required to render substantial services as a condition to receiving the prize or award.

Within the context of a business relationship, prizes and awards that would otherwise be includible in a recipient's gross income were excludable if they qualified as gifts under section 102. In general, section 274(b) disallowed an employer a business deduction for gifts to an employee to the extent that the total cost of all gifts of cash, tangible personal property, and other items to the same individual during the taxable year exceeded \$25. A special exception to the \$25 limitation was allowed for items of tangible personal property awarded to an employee for length of service, safety achievement, or productivity. The employer could deduct the cost of such an award up to \$400. If the item was provided under a qualified award plan, the deductibility limitation was increased to \$1600, provided the average cost of all plan awards made during the year did not exceed \$400. A de minimis fringe benefit under section 132(e) was, and continues to be, excludable from gross income and is not subject to the requirements imposed upon prizes and awards under sections 74 and 274.

### **Explanation of Provisions**

These proposed amendments relate to the excludability of certain prizes and awards and to the deductibility of certain employee awards and reflect the substantial changes made by the Tax Reform Act of 1986 (the Act) to *sections 74, 102 and 274 of the Internal Revenue Code* (Code). Changes to the applicable sections of the Code and regulations, amended or newly incorporated by this document, are effective for awards made after December 31, 1986.

Under the Act, the section 74(b) exclusion for prizes or awards received in recognition of charitable achievement is available only if the payor transfers the prize or award to one or more entities described in paragraph (1) and/or (2) of section 170(c), pursuant to the direction of the recipient.

Section 1.74-1(c) of the proposed regulations requires that recipients of prizes and awards clearly designate, in writing, within 45 days of the date the item is granted that they wish to have the prize or award transferred to one or more qualifying donee organizations. The proposed regulations set forth requirements which, in certain instances, determine whether a qualifying designation has been made.

Section 1.74-1(d) of the proposed regulations clarifies that the exclusion under section 74(b) will not be available unless the prize or award is transferred by the payor to one or more qualified donee organizations before the recipient, or any person other than the grantor or a qualified donee organization, uses the item. In general, a transfer may be accomplished by any method that results in receipt of the prize or award by, or on behalf of, one or more qualified donee organizations.

Section 1.74-1(e) further clarifies the requirements of section 74(b) by defining certain terms. Definitions are included which determine what constitutes a "qualified donee organization," when a "disqualifying use" has taken place, and when an item is considered "granted."

Section 1.74-1(f) provides that neither the payor nor the recipient of the prize or award may claim a charitable contribution deduction for the value of any prize or award for which an exclusion is allowed under section 74(b).

All of the requirements of section 74(b) in existence prior to passage of the Act remain in effect and must be met in order for the award recipient to be eligible for the exclusion. Accordingly, rules and regulations governing these additional requirements, to the extent they are not inconsistent with the proposed regulations, will remain in effect.

New Code section 74(c) excludes certain employee achievement awards from gross income. The exclusion applies, subject to certain limitations, to the value of awards made by the employer for safety achievement or length of service achievement. The amount of the exclusion generally corresponds with the deduction given the employer under new section 274(j) for these "employee achievement awards." Thus, in general, the employee must include these awards in income to the extent that the fair market value of the award, or, if greater, the cost of the award to the employer, exceeds the amount deductible under section 274(j). The exclusion allows an employee to exclude the full fair market value of the award where the cost of the award is fully deductible by the employer.

Section 1.74-2(d) of the proposed regulations provides special rules for employee achievement awards applicable to sole-proprietors and tax-exempt employers.

Section 1.74-2(e) clarifies that an employee award, whether or not an employee achievement award, may be excludible from gross income as a de minimis fringe benefit under section 132(e).

Section 102(c) of the Code clarifies that, with the exception of employee achievement awards under section 74(c) and de minimis fringe benefits under section 132(e), an employee shall not exclude from gross income any amount transferred to the employee (or for the employee's benefit) by, or on behalf of, the employer in the form of a gift, bequest, devise, or inheritance. Therefore, while awards satisfying the requirements of section 74(c) and de minimis fringe benefits qualifying under section 132(e) will be excluded from gross income under those sections, no amounts (except in certain narrowly defined circumstances) transferred by, or on behalf of, an individual's employer will be excludable from gross income under section 102.

Section 1.102-1(f)(2) of the proposed regulations provides that for purposes of section 102(c), extraordinary transfers to the natural objects of one's bounty will not be considered transfers for the benefit of an employee if it can be shown that the transfer was not made in recognition of the transferee's employment. Thus, the rules set out in *Comm. v. Duberstein*, 363 U.S. 278 (1960), formerly applicable in the determination of whether all property transferred inter vivos from an employer to an employee constitutes a gift, will only be applicable where the transferee employee would be the natural object of the employer's bounty.

From an employer's perspective, the Act substantially modifies an employer's ability to deduct the cost of certain employee awards. New section 274(j) defines deductible "employee achievement awards" to include only those awards made for length of service or safety achievement. In addition, an employee achievement award must be an item of tangible personal property awarded as part of a meaningful presentation and made under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.

Section 274(j) also establishes a limit on the amount that may be deducted by an employer. The annual deduction limitation per employee is \$400 for employee achievement awards that are not awarded as part of a qualified award plan. The annual deduction limitation per employee is \$1,600 for employee achievement awards that are awarded as part of a qualified award plan. In no event may an employer deduct more than \$1,600 per employee for all employee achievement awards made during the year. An award is not a qualified plan award where the average cost of all employee achievement awards made by the employer pursuant to a plan exceeds \$400 during the taxable year.

Section 1.274-8(b) of the proposed regulations clarifies that the \$1,600 deduction limitation applies in the aggregate, so that the \$1,600 limitation for qualified plan awards and the \$400 limitation for employee achievement awards that are not qualified plan awards cannot be added together to allow deductions exceeding \$1,600 for employee achievement awards made to an employee in a taxable year.

Section 1.274-8(c)(2) of the proposed regulations provides that tangible personal property does not include cash or any gift certificate other than a nonnegotiable gift certificate conferring only the right to receive tangible personal prop-

erty. The proposed regulations also give examples of what will be considered to create a significant likelihood of the payment of disguised compensation. For example, the providing of employee achievement awards in a manner that discriminates in favor of highly paid employees will be considered to be a payment of disguised compensation.

Section 1.274-8(c)(5) of the proposed regulations defines a "qualified plan award" as an employee achievement award presented pursuant to an established written award plan or program of the employer that does not discriminate as to eligibility or benefits.

Section 1.274-8(d)(1) of the proposed regulations states that the deduction limitations shall apply to a partnership as well as to each member of the partnership. Paragraph (d)(2) provides that the cost of length of service achievement awards (other than awards excludable under section 132(e)) may only be deducted by the employer if the employee has at least 5 years of service with the employer and has not received a length of service achievement award during that year or any of the 4 prior years. In addition, this paragraph clarifies that although a retirement award will be treated as having been provided for length of service achievement, it may also qualify for treatment as a de minimis fringe benefit under section 132(e) of the Code. Paragraph (d)(3) provides guidance with respect to safety achievement awards. An employer may deduct the cost of safety achievement awards only when presented to no more than 10 percent of an employer's eligible employees. Eligible employees include any employee who has worked for the employer in full time capacity for at least one year and who is not a manager, administrator, clerical employee, or other professional employee. Special rules clarify that in the case where more than 10 percent of an employer's eligible employees receive a safety achievement award, no award will be considered to be awarded for safety achievement if it cannot be determined that the award was presented before the 10 percent limitation was exceeded.

The Act specifically excludes awards qualifying as de minimis fringe benefits under section 132(e) from the requirements for length of service achievement and safety achievement. As a result, employers are not required to consider section 132(e) awards in determining whether employee achievement awards comply with the 5 year limitations for length of service achievement and the 10 percent eligible employee limitations for safety achievement.

### **Special Analyses**

The Commissioner of Internal Revenue has determined that this proposed rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required. The Internal Revenue Service has concluded that although this document is a notice of proposed rulemaking that solicits public comment, the regulations proposed herein are interpretative and the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, no Regulatory Flexibility Analysis is required for this rule.

### **Comments And Requests For a Public Hearing**

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of time and place will be published in the Federal Register.

### **Drafting Information**

The principal author of these proposed regulations is Christopher J. Wilson, formerly of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, on matters of both substance and style.

### **List of Subjects in 26 CFR Parts 1.61-1 Through 1.281-4**

Income taxes, Taxable income, Deductions, Exemptions.

### **Proposed Amendments to The Regulations**

The proposed amendments to 26 CFR Part 1 are as follows:

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