Tax Treatment of Incentive Payments

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Through a new program, government and private funders will assist at least 200 low-income families to gain self-sufficiency. The program will create incentives aimed at motivating families to develop their own pathways out of poverty. Participating families will receive up to $4,000 per year for achieving certain goals that improve their well being, both personally and in their community, such as completing education programs, saving money, enrolling in health care plans, and participating in support group meetings. Participating families will help design the incentives, and must document their accomplishments quarterly. Families participate for two years, and then new families are included in the program.

Three types of incentives will be offered:

1. Pre-set indicators of progress that a benchmark has been attained. For example, if a family member graduates from a training program, the family can earn a specified amount depending on the degree obtained.
2. Participation incentives. For example, a family can earn a specified amount for every meeting attended.
3. Self-defined incentives agreed upon by the family's peer group and approved by the program staff. For example, a family can earn a specified amount for completing an English class, if that goal is chosen by the family and agreed upon by the peer group and the program staff.

The program will provide other assistance that enables participating families to build a network of resources. In addition, the program will provide Individual Development Accounts (IDAs) and financial literacy training. Each family will also receive a $250 cash award and a computer at the beginning of their participation in the Initiative, along with computer training.

The program intends to operate as a nonprofit, Internal Revenue Code Section 501(c)(3) tax-exempt charitable corporation. The program currently operates as an initiative under a charitable fiscal sponsor.

1. What are the tax consequences of incentive payments on participating families and the program?
2. Do the tax consequences change if instead of cash, participating families receive merchandise, gift certificates for merchandise, or points that can be redeemed for merchandise donated to the program?

What are the tax consequences of incentive payments on participating families?

Section 61 of the Internal Revenue Code (IRC) provides that gross income includes income from all sources, unless specifically excluded. Gross income includes earned income from services performed as an employee or independent contractor, and unearned income from interest, dividends, and other sources. An employee or independent contractor is generally defined as a person engaged to do something for the benefit of another person. The participating families do something for their own benefit, not for the benefit of the program, and are thus not employees or independent contractors. The participating families need not pay FICA (social security) taxes on the incentive payments.

Among the items specifically included in income are prizes and awards, IRC Section 74.

Among the items specifically excluded from income are scholarships or fellowships received by an individual who is a candidate for a degree at an educational institution and who uses the grant for tuition and related expenses such as books and supplies, IRC Section 117. However, payments for services provided by the student, such as teaching or research, and required as a condition of receiving the scholarship are included in income. Also included in income are prizes that do not have to be used for educational purposes, even if so used.

Excluded from income are certain gifts and inheritances received from individuals, but not corporations, IRC Section 102.

Finally, welfare and other public assistance benefits are excluded from income. See Internal Revenue Service (IRS) Publication 525, Taxable and Nontaxable Income. This exclusion applies to payments from a state welfare agency for taking part in a work-training program, payments to the disabled for their training and rehabilitation, payments made by a state to reduce the cost of energy, food benefits under government nutrition programs, and disaster relief grants. This exclusion does not apply to payments made by charitable corporations to assist the needy.

Based on the description of the program incentive payments and the tax laws cited above, it is reasonable to conclude that the incentive payments (including the $250 up-front cash award) are includible in the gross income of participating families as prizes and awards. The exclusion of scholarship and fellowship income does not apply, since the incentive payments are made after graduation and need not be used to pay for educational expenses.

Not all gross income is taxable, however. Taxable income is gross income minus certain adjustments, the deduction for personal exemptions, and the standard deduction or certain itemized deductions. **If the program incentive payments, when combined with other family income, do not exceed the allowance for personal exemptions and deductions, then the incentive payments are not subject to federal income tax.**

California income tax laws are the same as the federal tax laws cited above, although the California allowance for personal exemptions and the standard deduction are different from the allowance under federal law.

There are two modifications to the program that, if adopted, might exclude from income a portion of the incentive payments. First, the program could separately reimburse family expenses, such as transportation and child care, which the family would not have incurred but for the program, such as attending Initiative meetings and preparing Initiative reports (but not expenses incurred in completing a class or a training program, for example, since these activities benefit the family and could have been undertaken even if there were no program). For example, the $250 cash award might be excludible from income to the extent that it is designated as the program's reasonable estimate of a family's cost of Initiative participation.

Second, the program could make payments to the family member who achieved the goal, including a dependent child. Generally, a dependent child must file a separate income tax return for his or her own income. The child's income is generally not included in the income of the parent(s), even though the parent(s) claim the child as a personal exemption on their income tax return.

However, an unmarried dependent child need not file an income tax return if his or her unearned income (from all sources, including the incentive payments) was $700 or less. Different rules apply if the child also had earned income. See IRS Publication 17, Your Federal Income Tax, for further details. Thus, a child's first $700 of unearned income, including incentive payments, is not subject to federal income tax. California income tax laws are the same.

What are the tax consequences of incentive payments on the program?

Charitable corporations cannot distribute their income to private individuals or benefit private parties except in furtherance of their charitable, tax-exempt purposes. **Based on the description of the program incentive payments summarized above, it seems reasonable to conclude that financial assistance to low-income needy families for the purposes specified in the Initiative furthers charitable, tax-exempt purposes.**

However, this conclusion is based on the assumption that no member of a participating family controls or has influence over the program through service on the advisory commission, the Board of Directors of the fiscal sponsor, the program Board of Directors when it incorporates, or by other means. If a member of a participating family controls or has influence over the program, further review of the circumstances of such control or influence and the individual's participation in the Initiative will be necessary in order to determine whether the requirements of IRC Section 501(c)(3) have been violated. At that time, it would also be necessary to determine the applicability of the IRC Section 4958 tax on excess benefit transactions with disqualified persons.

There are two types of IRC Section 501(c)(3) charitable tax-exempt corporations -- public charities and private foundations -- as defined in IRC Section 509. Grantmaking by private foundations is subject to additional scrutiny.

IRC Section 4945 imposes a tax on the taxable expenditures of private foundations. IRC Section 4945(d)(3) defines taxable expenditures to include grants to individuals for travel, study, or similar purposes. However, Section 4945(d)(3) does not apply to grants awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary of the Treasury, if the purpose of the grants is to improve the capacity, skill, or talent of the grantees, IRC Section 4945(g)(3). Also, grants to individuals for other purposes are not taxable expenditures. For example, it is not a taxable expenditure to make grants to indigent individuals to enable them to purchase furniture. See Treasury Regulation Section 53.4945-4(a)(3)(i).

Treasury Regulation Section 1.6033-3(a)(2) requires private foundations to report on their annual tax return to the IRS, available for public inspection, an itemized list of all grants made during the year, including the name and address of each recipient, other than grants to indigent or needy persons that do not exceed $1,000 during the year.

To avoid the additional scrutiny imposed on private foundation grants to individuals, the program fiscal sponsor should not be a private foundation, and the program should not become a private foundation when it obtains Section 501(c)(3) charitable tax-exempt status.

The program sponsor must report incentive payments of $600 or more in the previous year to any individual on box 3 of IRS Form 1099-MISC. Reports are made to both the recipient (by January 31) and the IRS (by February 28). To report the incentive payments, the program must request the recipient's social security or taxpayer identification number on IRS Form W-9 (an undocumented person who cannot obtain a social security number can apply for a taxpayer identification number for income tax reporting purposes on IRS Form W-7). If the program does not receive a signed IRS Form W-9, the PROGRAM must withhold certain amounts from each payment to that recipient (backup withholding). Recipients subject to backup withholding who do not owe income tax on the payments must file federal and California income tax returns in order to recover the amounts withheld.

Do the tax consequences change if instead of cash, participating families receive merchandise, gift certificates for merchandise, or points that can be redeemed for merchandise donated to the program?

The tax consequences to the family do not change. Gross income includes the fair market value of prizes and awards in goods or services. Treasury Regulation Section 1.74-1(a)(2).

The program should determine the fair market value of non-cash incentive payments (including the value of the computer given at the beginning of participation in the Initiative), and include this amount in its notification to the recipient family member on IRS Form 1099-MISC by January 31 of the following year for incentive payments that total $600 or more. The recipient must determine the fair market value of non-cash incentive payments that, when combined with cash payments, total less than $600 for which no Form 1099-MISC is submitted and for which the program does not determine the fair market value.

Note that the program must determine the fair market value of goods or services at the time of payment to the family member, not upon the program's receipt of the donation. The donor determines the fair market value of donated merchandise at the time of the donation, but only for the donor's income tax return, and need not disclose its determination to the PROGRAM unless the amount claimed as a charitable contribution deduction is over $5,000 and the donor files IRS Form 8283.

The fair market value of goods or services given as an incentive payment is included in income when the family receives the unconditional right to obtain the goods or services, whether or not the family exercises that right. Thus, the fair market value of a gift certificate is included as income when all conditions have been satisfied prior to exchanging the certificate for goods or services, whether or not the family actually exchanges the certificate for goods or services.

Points that can be redeemed for goods or services do not result in income until they are exchanged for the unconditional right to receive specific goods or services. Thus, for example, if a family can continue to accumulate points in order to receive goods or services of greater value, the family has income only when it exchanges the points for the unconditional right to receive specific goods or services. If points cannot be accumulated, but a family can choose among goods or services with different fair market values, the family has income only when it chooses to redeem the points for specific goods or services.

The program’s receipt of donated merchandise to be used for incentive payments provides additional support for the contention that the incentive payments further the program’s charitable tax-exempt purposes.