Prop. Reg. Section 1.74-2(c), Example 3
Special exclusion for certain employee achievement awards.

(a) General rule.

(1) Section 74(c) provides an exclusion from gross income for the value of an employee achievement award (as defined in section 274(j)) received by an employee if the cost to the employer of the award does not exceed the amount allowable as a deduction to the employer for the cost of the award. Thus, where the cost to the employer of an employee achievement award is fully deductible after considering the limitation under section 274(j), the value representing the employer's cost of the award is excludable from the employee's gross income.

(2) Where the cost of an award to the employer is so disproportionate to the fair market value of the award that there is a significant likelihood that the award was given as disguised compensation, no portion of the award will qualify as an employee achievement award excludable under the provisions of this section (see also §1.274-8(c)(1) and (4)).

(b) Excess deduction award. Where the cost to the employer of an employee achievement award exceeds the amount allowable as a deduction to the employer, the recipient must include in gross income an amount which is the greater of (1) the excess of such cost over the amount that is allowable as a deduction (but not to exceed the fair market value of the award) or (2) the excess of the fair market value of the award over the amount allowable as a deduction to the employer.

(c) Examples. The operation of this section may be illustrated by the following examples:

Example (1). An employer makes a qualifying length of service award to an employee in the form of a television set. Assume that the deduction limitation under section 274(j)(2) applicable to the award is $400. Assume also that the cost of the television set to the employer was $350, and that the fair market value of the television set is $475. The amount excludable is $475 (the full fair market value of the television set). This is true even though the fair market value exceeds both the cost of the television set to the employer and the $400 deduction allowable to the employer for non-qualified plan awards under section 274(j)(2)(A).

Example (2). Assume the same facts as in example (1) except that the fair market value of the television set is $900. Under these circumstances, the fair market value of the television set is so disproportionate to the cost of the item to the employer that the item will be considered payment of disguised compensation. As a result, no portion of the award will qualify as an employee achievement award. Since no portion of the award is excludable by the employee, the employer must report the full fair market value of the award as compensation on the employee's Form W-2.
Example (3). An employer makes a qualifying safety achievement award to an employee in the form of a pearl necklace. Assume that the deduction limitation under section 274(j) is $400. Assume also that the cost of the necklace to the employer is $425 and that the fair market value of the necklace is $475. The amount includible by the employee in gross income is the greater of (a) $25 (the difference between the cost of the item ($425) and the employer's deductible amount of $400) or (b) $75 (the amount by which the fair market value of the award ($475) exceeds the employer's deductible amount of $400). Accordingly, $75 is the amount includible in the employee's gross income. The remaining portion of the fair market value of the award (i.e., the $400 amount allowable as a deduction to the employer) is not included in the gross income of the employee. If the cost of the pearl necklace to the employer was $500 instead of $425, then $100 would be includible in the employee's gross income because the excess of the cost of the award over $400 (i.e., $100) is greater than the excess of the fair market value of the award over $400 (i.e., $75). The employer must report the $75, which is includible in the employee's gross income, as compensation on the employee's Form W-2.

Example (4). An employer invites its employees to attend a party it is sponsoring to benefit a charity. In order to encourage the employees to attend the party and to make contributions to the charity, the employer promises to match the employees' contributions and also provides expensive prizes to be awarded to contributing employees selected at random. Each employee receiving a prize must include the full fair market value of the prize in gross income because the prizes are not qualifying achievement awards under section 274(j) or de minimis fringe benefits under section 132(e). Since the prizes are not excludable, the employer must report the full fair market value of the prize as compensation on the employee's Form W-2.

(d) Special rules.

(1) The exclusion provided by this section shall not be available for any award made by a sole proprietorship to the sole proprietor.

(2) In the case of an employer exempt from taxation under Subtitle A of the Code, any reference in this section to the amount allowable as a deduction to the employer shall be treated as a reference to the amount which would be allowable as a deduction to the employer if the employer were not exempt from taxation under Subtitle A of the Code.

(e) Exclusion for certain de minimis fringe benefits. Nothing contained in this section shall preclude the exclusion of the value of an employee award that is otherwise qualified for exclusion under section 132(e).