Gift Giving from Residents to Employees – Income to employee? Deductible to Resident?

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With the holiday season approaching, residents are beginning to consider gifts to the Community’s employees for their loyal service all year. While we all would like the ability to just graciously give or accept gifts from the heart such as these without worrying about tax consequences, many questions arise regarding the tax consequences of such gifts. Much depends on the process chosen for the gift giving.

While practices in the industry vary, common gift methods include,
1. Residents individually give gifts directly to the employee;
2. A resident fund created for pooling and administering the gifts directly to the employees; or
3. Gifts are given to the Community organization for administering to the employees, either from such a fund or from the residents directly.

While residents would enjoy a tax deductible charitable contribution for the gift and the employees would prefer the gift to be nontaxable to them, this sort of double dipping is not the outcome.

First, let’s look at Scenario #1 – the residents individually provide the gifts directly to the employees. It probably is no surprise that in this situation there would be no charitable deduction to the residents. The question that frequently arises in this situation is whether the gift is taxable income to the employees or mere nontaxable gifts.

To constitute a gift for purposes of federal tax law, a transfer of money or property must be made out of a feeling of disinterested generosity. The payment must be in the nature of “something for nothing.” It is not a gift if the payment is a reward for services rendered. With regard to payments made by a resident to a service provider, it is difficult to argue that such payments constitute gifts, even when the amounts are paid at the holidays. In addition, it is more difficult to make that argument when payments made by residents are pooled together and allocated to service providers based on the number of hours that such provider(s) worked in a given time period, or some other metric that is related to the provider’s employment.

Thus, the payment to the employee in most situations should be viewed as tip income which is taxable to the employee. Cash and noncash tips are subject to income tax. All of the facts and circumstances must be considered, however, all of these factors should be present to classify a payment as a tip:
(1) The payment made free from compulsion;
(2) The resident has the unrestricted right to determine the amount;
(3) The payment is not the subject of negotiation or dictated by employer policy;
(4) The resident has the right to determine who receives the payment.

Such tips also are subject to income tax withholding and with some exceptions, FICA withholding. Tips under $20 in any one month or noncash tips are not subject to FICA although they are subject to income tax. If an employee receives more than $20 of tips in any month, then the employee should report the receipt of the tips to the employer so that the employer can withhold the proper amount and report the tips as other wages and tips on the W-2 of the employee. The withholding is taken from the wages of the employee (other than tips) or from other funds made available by the employee for this purpose. If the employee does not report the tips to the employer, the employee still is responsible for paying
income tax and the employee portion of FICA. In such case, the employer portion of FICA only would be payable when the employer receives a written notice and demand from the IRS.

Next, let’s look at Scenario #2 – the residents create a fund into which they contribute cash and payments are made directly from the fund to the employees. This fund can either be just a collection of cash or a separate legal entity. If the gifts are provided from a fund that is not a separate legal entity, then the gifts are in essence coming directly from the residents to the employees as discussed in Scenario #1. The more controversial question is, if the fund is created as a separate 501(c)(3) tax exempt entity, can the contribution to this exempt entity for gifts to employees be a tax deductible contribution?

The answer to this depends on whether the entity is acting merely as an agent for the residents or if the entity has control of the funds and can spend it as it wishes. Whether or not the entity is acting merely as an agent is a question of facts and circumstances. Do the residents have control of the entity’s actions in the transaction? Is there a written agreement obligating the entity with respect to the transaction? Is the entity holding itself out as an agent of the residents for this transaction? If the gifts are earmarked for the employees and the entity does not have the authority to spend the money in any way it deems fit, then the entity should be viewed as an agent acting on behalf of the residents, and the conclusion is the same as Scenario #1. If the entity has full control and discretion as to the use of the funds, then the gift should be deemed a contribution to the tax exempt entity and thus a charitable deduction should be allowable. In that case appropriate acknowledgments of the charitable contributions should be given to the resident contributors.

The tax treatment of the gift to the employee from the entity would have to be analyzed in accordance with the definitions discussed in Scenario #1 to determine whether it is a tip or a gift.

Scenario #3 places the community organization in the place of the fund discussed in Scenario #2. In this scenario, the charitable community organization receives the contributions directly from the residents and in turn provides the payments to its employees.

The analysis of this scenario is much the same as scenario #2. Tips not only include amounts received directly from residents, but also amounts paid to the employee by the employer on behalf of the residents. Thus if the charitable community organization is acting as an agent for the residents, then the conclusion is the same as scenario #1, specifically, no charitable deduction for the residents and likely taxable tip income to the employees. If the charitable community organization has full control and discretion over the funds and thus can spend it in any way it decides, then there should be a charitable contribution on the part of the residents. However, the income should still be taxable to the employee, but in this case as regular wages, not tip income and should be treated as such in the employer’s accounting and payroll reporting.

Thus, in none of these scenarios does the employee receive tax free income, unless the gift is in no way connected to the services they provide, which is a difficult position to take even in scenarios #1 and #2, and nearly impossible when coming from the employer itself. Therefore, employers should encourage employees to report tips to the employer if the amount of the tip is at least $20 in any month and the employer should report the tips on the W-2 and withhold the proper amount.

Whatever scenario best fits your organization’s practices, be sure to provide proper donor acknowledgments for charitable contributions and proper employee records and tax withholding for tips or wages. As a first step, decide which scenario best fits the organization’s desires going forward, regardless of how these gifts have been handled in the past. Then speak to your tax advisor about proper reporting and structuring for the chosen scenario in future years and how to handle any required reporting for potential past errors.

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