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Memorandum

TO: Deposition Reporters Association of California
California Court Reporters Association

FROM: Wendy L. Tauriainen

DATE: February 11, 2011

RE: **Taxation of incentives given by court and deposition reporting firms**

I. Issue Presented.

Deposition and court reporting firms ("Reporting Firms") often provide incentives to legal assistants, attorneys, and others in exchange for booking the Reporting Firm's services. These incentives can have significant value, such as bottles of champagne, video game systems, department store gift cards, and points to be earned toward vacations. This memo will analyze the tax consequences to both Reporting Firms and recipients of such incentives.

II. Tax Consequences to Recipients.

The IRS has recently become more attuned to the issue of treating so-called "gifts" as income. In 2006, the IRS reached a settlement with the Academy of Motion Picture Arts and Sciences involving the value of gift bags distributed to presenters and performers of its Academy Award shows.[1] The IRS stated that the recipients of these gift bags generally must report the fair market value of the bag and its contents as income.[2] While the gift bags are called "gifts," they are not gifts for income tax purposes because they are not given "solely out of affection, respect, or similar impulses for the recipients of the gift bags."[3] Instead, they were provided in exchange for the artist performing or presenting at the Awards show.[4] The settlement between the IRS and the Academy involved the Academy's promise that it would distribute tax information to recipients of the gift bags notifying them of their responsibility to satisfy their tax obligations.[5] The IRS news release regarding the settlement stated that the IRS would continue to focus on compliance by recipients to ensure that the fair market value of the gifts is reported as income.[6] The IRS also stated it would continue to monitor compliance by the providers of gift bags to ensure that Form 1099s are issued to recipients.[7] The Academy has since discontinued

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1 IRS News Release IR-2006-128.
2 IRS "Gift Bag Questions and Answers". (2006),http://www.irs.gov/newsroom/article/0,,id=161153,00.html.
3 *Id.*
4 http://www.irs.gov/pub/irs-utl/academyawards.pdf.
5 IRS News Release IR-2006-128.
6 *Id.*
7 *Id.*

the practice.[8] The Reporting Firm incentives are very similar to the awards shows gift bags -- they are things of value in exchange for a benefit conferred -- and should be treated similarly to ensure compliance with tax rules.

A. Gift or Payment for Services?

The tax consequences to the recipient depends on whether the incentive is a gift or payment for a service. True gifts are not included in the gross income of the recipient.[9] Whether or not a transfer is a gift is determined by examining the intent of the transferor.[10] The absence of a legal or moral obligation to make the transfer does not make the transfer a gift.[11] An incentive will be treated as a taxable payment for services unless the motive for the transfer is "detached and disinterested generosity" made out of "affection, respect, admiration, charity or like impulses."[12] This is true even if the transferor receives no economic benefit from the transfer.[13]

Incentives given by Reporting Firms in exchange for bookings will not be treated as gifts for tax purposes because there is a clear relationship between the incentive and the performance of a service by the recipient. The *quid pro quo* nature of the transaction removes any possibility that the incentive is given out of disinterested generosity. Further, even if the incentive were characterized as a prize or award, the IRC specifically includes amounts received as prizes and awards in gross income unless the prize or award is transferred directly to a charity.[14]

Given that the incentives provided by Reporting Firms in exchange for business are payments for services rather than gifts, the IRC requires the recipients of those payments to treat the value of the incentives as gross income.[15] This means that recipients must report the value of the incentives they receive as income on their tax returns. Failure to do so could result in the assessment of additional taxes, interest and penalties by the Internal Revenue Service.

B. Can the Income Be Excluded by the Individual Recipient?

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[8] Academy of Motion Picture Arts and Sciences "Academy and IRS Reach Gift Basket Accord" (2006), http://www.irs.gov/pub/irs-utl/academyawards.pdf.
[9] IRC Section 102.
[10] See *Commissioner v. Duberstein*, 363 U.S. 278 (1960) ("Gift" to taxpayer of automobile in recognition of business referrals made to business friend was payment for services despite taxpayer's reluctance to accept gift).
[11] See *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 730 (1929) (Payment by employer of employee's income taxes was not a gift despite lack of obligation on employer's part for such payment).
[12] See *Commissioner v. LoBue*, 351 U.S. 243, 246 (1956) (Transfer of stock options to employee not made "with the kind of detached and disinterested generosity which might evidence a 'gift' in the statutory sense."); *Robertson v. United States*, 343 U.S. 711, 714 (1952) (Taxpayer's receipt of prize money for a winning symphonic composition constituted taxable income rather than a gift).
[13] See *Robertson*, 343 U.S. at 714.
[14] IRC Section 74; Treas. Regs. Section 1.74-1(a)(1).
[15] IRC Section 61(a). (Stating gross income means income from whatever source derived, including compensation for services, including fees, commissions, fringe benefits, and similar items.)

1. Incentive Given by Reporting Firm to Individual.

Where the incentive is given directly by the Reporting Firm to an individual attorney or law firm employee, it is unlikely that an individual attorney or law firm employee could exclude the value of the incentives from income. Given the "payment for services" nature of the incentives, the fair market value of the incentives must be reported by these recipients as taxable income.

2. Incentive Given by Reporting Firm to Law Firm.

Similarly, an incentive given by the Reporting Firm to a law firm, which then transfers the incentive to its employee, may also be includible in the employee's taxable income. Gifts by an employer to an employee may not be excluded from being considered income of the employee.[16] However, the IRC does permit the exclusion from income of certain fringe benefits.[17] Thus, whether the law firm must impute income to the employee for the value of any incentives the law firm receives from a Reporting Firm and then passes on to an employee depends on whether the incentive falls under any of the exceptions in the fringe benefit rules.

The only fringe benefit exception which could apply to incentives is the “de minimis fringe.” A de minimis fringe benefit is one which is so small as to make accounting for it unreasonable or administratively impracticable.[18] While de minimis fringe benefits can be deducted as business expenses, they will not be included in the recipient’s gross income.[19] The Treasury Regulations give examples of benefits which do and do not qualify as de minimis. For example, occasional typing of personal letters by a company secretary, occasional cocktail parties, traditional birthday or holiday gifts of property with a low fair market value (but not cash), and flowers provided on account of illness are all de minimis fringe benefits and may be excluded from gross income.[20] By contrast, season tickets to sporting or theater events, membership dues to a country club or gym, or even use of an employer-provided vehicle more than once a month are not de minimis fringe benefits and must be included in income.[21] Further, no cash or cash equivalent (such as a gift certificate or gift card) will qualify as a de minimis fringe benefit.[22]

The value of the incentive provided to the law firm by the Reporting firm, and then passed onto the employee, may or may not be excludible from the employee’s income under the de minimis fringe benefit exception depending on the nature and value of the incentive. A department store gift card will never be excludible because it is a cash equivalent. Items like theater tickets or group meals may be excludible assuming they are given so infrequently both to the employees as a whole and to individual employees as to make

[16] IRC Section 102(c).
[17] IRC Section 132(a).
[18] IRC Section 132(e).
[19] See, *e.g.*, IRS Field Service Advice 200219005 (December 31, 2001).
[20] Treas. Reg. Section 1.132-6(e)(1).
[21] Treas. Reg. Section 1.132-6(e)(2).
[22] Treas. Reg. Section 1.132-6(c).

accounting for them unreasonable or impracticable.[23] Of course, determining how frequently or infrequently these items are distributed, and to whom, requires some degree of administrative tracking, which necessarily hinders an argument that such tracking is unreasonable or impracticable.

If the law firm determines that the fringe benefit is not excludible as a de minimis fringe, it must include the fair market value of the benefit in the employee's wages and withhold the appropriate employment taxes. Failure to do so could subject the law firm to additional taxes, penalties and interest. Further, the employer could be required to issue amended W-2s to affected employees who would then be required to file amended tax returns and possibly pay additional tax, interest and penalties.

3. Similarity of Some Kind of Incentives to Tips.

Alternatively, a law firm may be required to withhold and pay employment taxes based on the kind of the incentive received by the employee because of the similarity of incentives to tips. Similar to tips, incentives are paid by Reporting firms to a law firm's employees and are payments made in the course of the employee's employment. Employees are required to report to their employer cash tips received in amounts over $20 in one month.[24] Employers are then obligated to withhold employment taxes from those amounts. "Cash" tips for these purposes includes "monetary media of exchange."[25] Tips paid in the forms of passes, tickets and other goods or commodities are not included in the employee's wages.[26] Thus, where incentives are paid in the form of things like pre-paid charge cards, or other cash-equivalents, an analogy can be drawn to the reporting and withholding requirements which apply to tips, leaving the employee potentially obligated to report the value of the cash-equivalent incentives to the employer and the employer potentially obligated to withhold employment taxes on those amounts.

4. Tax Liability of Law Firm for Incentives Paid To Their Employees Acting Within the Scope Of Their Employment.

When an incentive is provided to, say, a paralegal or a secretary for booking a deposition at the instruction of a member or another employee of the firm, the question arises: who is the recipient of the incentive, the law firm or the employee? No authority found conclusively determines the answer. Law firms therefore cannot with precision predict how the Internal Revenue Service will treat the matter and, in fact, the issue may turn on the specific facts of each case. As discussed in the Conclusion, law firms may want seriously to weigh the pros and cons of permitting their employees to receive such incentive gifts, for this and all of the other reasons just discussed.

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[23] Treas. Reg. Section 1.132-6(b).
[24] IRC Section 6053(a).
[25] Treas. Reg. § 31.3121(a)(12)-1.
[26] *Id.*

III. Tax Consequences to Reporting Firms.

A. Treatment of Incentives as "Kickbacks."

IRC Section 162(c)(2) disallows business expense deductions for payment of illegal "kickbacks." Kickbacks are defined as payments that could subject the payor to criminal penalty or the loss of license or privilege to engage in a trade or business.[27] Under the California Code of Regulations, the Court Reporters Board of California may suspend, revoke or deny certification of a shorthand reporter for directly or indirectly giving any gift, incentive, reward or anything with a value exceeding $100 in aggregate during a calendar year to any person or entity associated with a proceeding being reported.[28] This rule also applies to Reporting Firms which are corporations and thus under the jurisdiction of the Court Reporters Board of California.[29] While Reporting Firms that qualify as "professional corporations" under California Corporations Code section 13401(b) themselves are not required to be licensed, they are nevertheless in the view of the California Court Reporters Board subject to the statutes and regulations governing licensees.[30] California Business & Professions Code section 8019 makes any violation of the statutes regulating the profession a misdemeanor. Thus, if a Reporting Firm provides an incentive that violates the statutes in the Business & Professions Code, it also commits a misdemeanor, making application of IRC Section 162(c)(2) a possibility.

B. Treatment of Incentives as Gifts.

Reporting Firms may be incorrectly treating the incentives given to specific individuals in exchange for business as "gifts" and deducting some or all of the cost of the incentive as a business expense. The IRC allows a business expense deduction for gifts to an individual which do not exceed $25 in one year.[31] However, to be deductible under this rule, the gift must be an item which is not included in the recipient's gross income. For these purposes, "gifts" include packaged food to be consumed later and tickets to a place for entertainment as long as the transferor does not accompany the recipient.[32] As discussed in Section II above, Tax Consequences to Recipients, these incentives do not qualify as gifts for this purpose and may not be deducted as a business expense under this rule.

The IRC also allows a business expense deduction for incentives given to a recipient other than an employee of the transferor, *as long as the value of the incentive is includible in the*

[27] IRC Section 162(c)(2).
[28] California Code of Regulations Section 2475(a) and (b).
[29] California Business and Professions Code Section 8046; California Code of Regulations Section 2468(a).
[30] On October 26, 2010 the California Court Reporters Board issues an administrative citation and fine against U.S.Legal for violating Business & Professions Code section 8046 and the Board's regulations regulating gifts. http://www.courtreportersboard.ca.gov/lawsregs/cite-fine.pdf ,
[31] IRC Section 274(b)(1). ("No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25.")
[32] Treas. Reg. Section 1.274-2(b)(1)(iii)(b).

recipient's gross income.[33] This section is an exception to the rule disallowing deductions for entertainment expenses. If the incentive is something in the nature of "entertainment," it will only be deductible if specific requirements are met. For these purposes, entertainment includes things like vacations given out in exchange for services performed.[34] However, to be deductible under this rule, the Reporting Firm must issue a Form 1099 to the recipient if the total value of the incentives in one year exceeds $600.[35]

C. Gifts to Law Firms.

As discussed above, IRC Section 274(b) limits the deductibility of gifts to individuals to $25. However, because the section refers to a gift to *an individual*, gifts to law firms in amounts over $25 may be deductible. To be deductible, the Reporting Firm must make the gift with no intention that it will be enjoyed by any particular person and the Reporting Firm must not reasonably be able to ascertain the ultimate recipient of the gift.[36] This means that, to qualify for this exception from the $25 limit, the law firm must be large enough that the Reporting Firm can reasonably claim it did not know who the ultimate recipient would be. Recalling that this deals only with whether the Reporting Firm may deduct the cost of the incentive, not to whether the incentive is income to someone or something else, the likelihood of this argument succeeding when, as here, the incentive is provided in exchange for booking identifiable business is unclear.

The deduction available for gifts to business entities seems to conflict with the Section 102 requirements that "gifts" must be made out of disinterested generosity. The deduction is aimed clearly at transfers where the transferor believes there is some business advantage to be gained, rather than pure generosity. However, the Treasury Regulations regarding these gifts refer to items like theater tickets, books and "several" baseball tickets.[37] It is arguable that gifts to law firms that exceed an as-yet undefined threshold, would no longer qualify as "gifts" and would not be deductible.

An additional complication is that, until recently, only payments made to law firms which operated as partnerships triggered the issuance of a Form 1099; payments made to law firms operating as corporations were exempt from the requirement.[38] However, a recent change in

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[33] IRC Section 274(e)(9) (Allows deduction of expenses "includible in the gross income of a recipient . . . who is not an employee of the taxpayer as compensation for services rendered or as a prize or award . . .")

[34] Treas. Reg. Section 1.274-2(c)(5) ("[I]f a manufacturer of products provides a vacation trip for retailers of his products who exceed sales quotas, as a prize or award includible in gross income, the expenditure will be considered directly related to the active conduct of the taxpayer's trade or business."); Treas. Reg. Section 1.274-2(b)(1)(iii)(a) ("[A]ny expenditure which might generally be considered either for a gift or entertainment, or considered either for travel or entertainment, shall be considered an expenditure for entertainment rather than for a gift or travel.")

[35] IRC Section 274(e)(9).

[36] Treas. Reg. Section. 1.274-3(e)(2).

[37] *Id.*

[38] The exemption does not extend to payments for legal services, which must be reported on Form 1099 whether or not the law firm is a partnership or a corporation. IRC Section 6045(f).

the law has eliminated the exemption for payments of more than $600 made to corporations after December 31, 2011.[39] Thus, for incentives over $600 paid in any year after December 31, 2011, Reporting Firms will be required to issue Form 1099s to both corporate law firms and partnerships. Reporting Firms unaware of this change who fail to issue Form 1099s to sole practitioners who practice law as corporations, could be subject to tax penalties.[40] Of course, as mentioned, even if the value of the incentive is less than $600 and the recipient doesn't receive a Form 1099, the recipient must still report the income unless it can be otherwise excluded.[41]

D. Substantiation Requirements.

Business expenses are not deductible unless the taxpayer properly substantiates the expense. This often means detailed recordkeeping about the nature of the expense including the recipient of the gift, the amount, and the purpose. A more thorough discussion of the substantiation rules is beyond the scope of this memo. However, failure to meet the requirements can have serious tax impacts to the Reporting Firm that improperly deducts incentive expenses without proper substantiation.

IV. Other Issues.

Incentive payments may also implicate state income tax rules and ethical issues. National and state court reporting associations and regulatory boards promulgate limits on the value of incentives which can be distributed per recipient on the grounds that such payments may taint the impartiality of the reporter with regard to the parties to the action.[42] Further, incentive payments by large Reporting Firms may violate the unfair competition rules of the California Business and Professions Code. These issues are not addressed in this memorandum, but we would be happy to do additional research if that would be useful.

V. Conclusion.

Incentives distributed to employees of law firms by Reporting Firms in exchange for bookings are not gifts. These incentives clearly represent income and must be reported by somebody, depending upon who the IRS deems the recipient to be. Aside from the ethical and professional prohibitions against these incentives, both recipients and the Reporting Firms risk potentially serious tax consequences, depending on the value of the incentives.

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[39] IRC Section 6041(i); Act Sec. 9006(c) of Patient Protection and Affordable Care Act (PPACA) (P.L. 111-148).
[40] IRC Section 6721. Failure to file penalties have been increased beginning with Form 1099s due after December 31, 2010. Penalties range from $30 per return for returns filed with correct information and no more than 30 days late to a minimum penalty of $250 per return for failing to file due to intentional disregard of the law.
[41] IRC Section 1.
[42] See, *e.g.*, National Court Reporters Association Code of Professional Ethics limiting incentives to $100 per recipient per year (http://ncraonline.org/NCRA/codeofethics/); see also California Code of Regulations Section 2475(b)(8) limiting incentives to $100 per recipient per year.

For attorneys and law firm employees, failing to report the value of the benefits received as income, and paying tax on that income, could result in the imposition of tax and penalties. Where law firms have policies in place prohibiting employees from accepting incentives, serious tax issues may still arise to the extent these policies are not enforced. Similarly, if a law firm receives the incentive and passes it along to an employee, there could be both income and employment tax consequences for the employee and the law firm.

Finally, a Reporting Firm that improperly deducts the cost of the incentives (for example where the incentives are actually kickbacks, the deduction exceeds the allowable amounts, or the Incentives are not properly substantiated) could also result in the imposition of additional tax and penalties on the Reporting Firm.

Overall, incentives provided in exchange for business present significant risks for both the Reporting Firms and the law firms and law firm employees who receive them.

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.