
# Summary of Legal Issues Affecting Non-Cash Award Programs

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## I. LEGAL ISSUES — EMPLOYEE ACHIEVEMENT AWARD PROGRAMS

Complying with section 274(j) of the Internal Revenue Code

**"Employee achievement awards."** Section 274(j) of the Code provides such awards can qualify for preferential tax treatment (non-taxable to the employee and deductible for the employer) if they are (i) "tangible personal property" (*i.e.*, merchandise) that an employer gives to an employee for safety or length of service achievement, and (ii) given to an employee as part of a meaningful presentation and under such conditions that it does not amount to disguised compensation.

**Cash, cash equivalents and most gift cards are not allowed.** The award cannot be in the form of cash or a gift certificate (other than a non-negotiable gift card conferring only the right to receive tangible personal property). The average cost of the award cannot exceed $400 per recipient. Any card that may be converted to cash is not "tangible personal property" and cannot qualify for preferential tax treatment. Other items that are not tangible personal property include, for example, travel, vacations, meals, lodging, tickets to theater or sporting events, and stocks, bonds, or other securities.

**Service Awards Programs.** Incentive companies and their employer clients should not face too many hurdles under Code section 274(j) or any other statute when operating a length of service award program. The most important requirement for a service award is that it can be excluded from an employee's income only if it is received by the employee after his first five years of service with the employer giving the award, and then only if the employee has not received another length of service award from his employer for at least five years. In other words, service programs can be given to an employee tax-free every five years.

**Safety award programs.** Safety awards can cause more legal problems. The biggest potential trap is that the employer can give a safety achievement award tax-free to 10% or less of its eligible full-time employees each year. After the 10% threshold is met, subsequent awards during the year are taxable.

**The FLSA and overtime pay issues.** If a safety award does not meet the statutory requirement of Code section 274(j), the value of the award would be additional taxable remuneration for employment under the Fair Labor Standards Act ("FLSA"). Incentive companies should be extremely careful that safety achievement awards qualify under Code section 274(j), or the employer would have to treat the award as additional compensation and could be liable for additional overtime to its employees under the FLSA. (The same potential concern exists for service award programs, but there are fewer legal requirements for an employer to meet to have a service award program qualify under Code section 274(j).)

**OSHA hostility toward safety incentive programs.** The Occupational Safety and Health Administration ("OSHA") does not understand or like safety incentive programs. Thus, employers and incentive companies need to take care in the way they design safety incentive programs to avoid running afoul of OSHA rules. In the preamble to a recently adopted final rule on record keeping and reporting of accidents, OSHA states that the rule does not prohibit safety incentive programs, but it does restrict their use.

OSHA states that an employer would violate the rule if it were to take adverse action against an employee for reporting a work-related injury or illness, regardless of whether such action is part

of an incentive program. For example, a safety incentive program that disqualifies an employee from receiving a bonus or award because the employee reported a work-related injury or illness would violate the rule because OSHA deems the denial of a bonus or award to be an adverse job action. Additionally, it believes that such a safety incentive program would deter or discourage a reasonable employee from reporting a work-related injury or illness. There are certain types of safety incentive programs that OSHA deems compliant. For example, if an incentive program makes an award contingent upon whether employees correctly follow legitimate safety rules such as wearing hard hats or protecting themselves from falls, rather than whether they reported any injuries or illnesses, the program would comply with the final rule.

The line between safety incentive programs that OSHA favors and those it does not is far from clear. Moreover, it is unclear if the final OSHA rule on record keeping and reporting of accidents would survive judicial scrutiny. For now, it provides another trap for the unwary and another potential hurdle in whether an employer would use a safety incentive program at all.

## II. LEGAL ISSUES — THE INVESTMENT ADVICE FIDUCIARY RULE

The Department of Labor ("DOL") has issued a new fiduciary rule that requires financial advisors to act in the best interests of their clients and put their clients' interests above their own. Financial advisors who wish to continue working on commission will need to provide clients with a disclosure agreement, called a "Best Interest Contract" ("BIC") exemption in circumstances where a conflict of interest could exist (for example, when the advisor receives a higher commission or special bonus for selling a certain product).

The DOL has advised that financial institutions may continue to use incentive compensation and awards for their financial advisors and still comply with the BIC exemption. It strongly cautioned, however, that any such arrangements must be carefully structured and monitored to avoid creating, or allowing the continuation of, incentives for financial advisors to act in a manner that would not be in the best interest of the retirement investor. For example, a financial institution should not pay an advisor a higher commission for selling a given mutual fund as opposed to another such fund if the two funds are similar products but the former has a higher payout to the financial institution. Incentives should be based upon "neutral" factors, such as the amount of work involved or other factors justifying distinctions in the amount of compensation payable to a financial advisor for selling certain categories of products.

Due to the new fiduciary rule, many financial institutions appear to be shying away from using any type of incentive or award program to motivate and/or compensate their employees. Given the level of uncertainty surrounding the fiduciary rule, they are concerned that any awards or incentives could potentially be deemed to run afoul of BIC exemptions. Although this is an overreaction, it is understandable in the context of prior law when conflicts were rife. Mutual fund companies competed to entice brokers and advisors to sell their funds to clients, regardless of what was in the best interest of the clients. As part of the enticement, they compensated intermediaries with trips to exclusive destinations and other lavish prizes, and they shared revenues with brokers.

The status of the fiduciary rule is uncertain currently, because President Trump issued an executive order and a draft presidential memorandum on February 3, 2017 instructing the DOL to conduct "economic and legal analysis" on the rule's potential impact, and the DOL has delayed its implementation until June 9, 2017 to collect more comments. If the DOL were to conclude

that the fiduciary rule hurts investors or firms, it can propose a rule "rescinding or revising" it. The actions of the president and the DOL will most likely delay the implementation of the rule by at least 180 days. It is nonetheless important to understand the fiduciary rule because, after several years of preparing for it, many mutual funds and other investment companies are in the process of complying with it regardless. Indeed, not only is there considerable momentum in favor of compliance within the finance industry, but the public supports the additional investor protections, as well.

## III. LEGAL ISSUES — GIFT CARDS

**Escheat laws.** There is no easy, uniform answer to questions regarding state unclaimed property (escheat) laws. First and foremost, gift card issuers must determine which state's escheat law might apply. Thus, gift card issuers must be aware of the lurking jurisdictional issues and resolve each factual situation as it arises. Some states exempt gift cards from escheat.

Gift card issuers should make sure that they comply with all applicable state escheat statutes, as escheat laws contain many traps for the unwary and navigating them can be fraught with risk. The look-back periods that states have for unclaimed property are often long, sometimes up to 20 years, with Delaware going back to 1981, which means that the costs of failing to comply with state escheat statutes can be high and potentially catastrophic. Over 80% of states conduct audits though private third-parties that have a strong incentive to assert that issuers have failed to report and pay over abandoned property because they work on a contingency basis (usually 10% of the amount collected).

**Dormancy and other administrative fees.** Once an issuer has determined which state's escheat laws may apply, it may be able to use reasonable annual administrative/dormancy fees to reduce or eliminate the unused portion of a gift card, provided such fees are permitted by state law and comply with federal law, the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "CARD Act"). Unless state law restricts (or prohibits) such dormancy charges, they could be an effective means of mitigating or eliminating the effect of escheat laws. It is worth noting that if a gift card is subject to escheat in a state, dormancy fees cannot be used to avoid escheat.

**Expiration dates.** Federal law provides that gift cards sold to consumers may not expire for a minimum of five years. The CARD Act notwithstanding, however, gift card issuers should be aware that an increasing number of states have followed the lead of California and prohibit the use of expiration dates on gift certificates.

**Choosing the right state to organize a gift card business.** Issuers who sell their gift cards to resellers usually do not know who has purchased or received a gift card and do not have purchaser records. In cases where the purchaser is unknown, a gift card would escheat to the state of the card issuer's incorporation or organization. Accordingly, these types of issuers may be able to avoid escheat by incorporating or organizing their business in a state that exempts gift cards from its escheat laws. Regardless of where they incorporate or organize, however, most gift card issuers will still have to comply with the restrictions that the federal CARD Act imposes on the use of expiration dates and dormancy fees.

**Gift cards used in an awards program.** When gift cards are used as part of a loyalty, award, or promotional program, they would be exempt from the CARD Act, and they would often be exempt from state laws that limit or prohibit use of dormancy/administrative fees and expiration

dates. Moreover, state laws often exempt gift cards used in loyalty, award, or promotional programs from their escheat statutes. Therefore, gift cards that are used in such programs may carry more restrictions than those sold to consumers. An incentive company and the employer/client should reach an understanding before the start of any award program with respect to the treatment of breakage (unredeemed gift cards) and the use of expiration dates and/or dormancy or administrative fees. Although expiration dates and fees may be permitted as a matter of law, incentive companies and their clients are likely to view expiration dates and fees from a different perspective.

## IV. LEGAL ISSUES — THE ANTI-MONEY LAUNDERING RULE, GIFT CARDS AND AWARD PROGRAMS

On July 26, 2011, the Financial Crimes Enforcement Network (FinCEN) issued a rule amending the Bank Secrecy Act regulations as they applied to a money services business (MSB) with respect to stored value or prepaid access cards. FinCEN has clarified that the distribution of prepaid access products to other businesses for further distribution or resale is not the type of activity intended to be covered by the prepaid access rule is helpful. This clarification eliminates most potential problems for bulk sales of closed loop prepaid access (*e.g.*, merchant cards) in the B2B context.

**Anti-money laundering rule could apply to gift cards in certain circumstances.** To avoid the anti-money laundering rule, a company must ensure that its own gift cards are truly closed loop, that not more than $2,000 maximum value can be associated with the card on any day, and that cards cannot be redeemed for cash (except as specifically required by law).

**Open loop prepaid cards.** If a company sells or reloads gift cards from other companies and open loop prepaid cards, it must not sell or reload cards under certain "prepaid programs" if such cards can be used before customer identification and verification. Anyone who sells such cards should confirm with the issuers that the cards cannot be used before customer identification and verification.

**High-value cards.** A company must not sell any prepaid cards having a combined value over $10,000 to any single person during any one day, and it must also implement policies and procedures reasonably adapted to prevent such sales. The policies and procedures must be based on risk of money laundering and appropriate to the vendor after taking into account its typical customers, location(s), and volume of prepaid access sales.

**Bulk sale of closed loop cards.** While the anti-money laundering rule should not have any effect on most award programs, incentive companies and their clients should be generally aware of the rule and its potential application. The incentive marketplace continues to work with FinCEN to ensure that the onerous customer information collection and recordkeeping obligations are not imposed on bulk sales for resale (or further distribution) of closed loop prepaid access cards.

## V. LEGAL ISSUES -- SALES AND USE TAXES AND NON-CASH AWARDS

**Obligation to collect and remit sales and use taxes.** An out-of-state seller who solicits sales by mail order or electronic means does not have to collect sales and use taxes on behalf of the purchaser's state of residence, unless the out-of-state seller had a "substantial nexus" with the purchaser's state. For these purposes, "substantial nexus" means some "physical presence" in the consumer's state. Sales outlets, such as stores, offices, sales representatives (including independent sales agents), any significant property, and equipment are some examples of

physical presence. Likewise, if a vendor makes more than a few visits to a customer, sends employees to train customers how to use a product, or sends employees to service a product, it may be creating physical presence in a state.

**Potential conflict between incentive companies and their clients.** Sales and use tax reporting and collection has the potential to create a stumbling block in any award program involving an incentive company or a fulfillment center. Many companies that use award programs have physical presence in most, if not all, states, whereas, incentive companies are more likely to have physical presence in a few states at most. Thus, when an incentive company ships merchandise to an employee redeeming points under an award program, it would probably not be required to collect sales or use taxes due to lack of physical presence in the state to which it ships. (There is some dispute whether the state where employer is located or where the employee resides would be entitled to impose its sales or use tax. In many cases the state where the employer and employee are located is the same.)

**State tax departments are pursuing sales tax revenue.** Because state tax departments would face a difficult legal task in requiring the incentive company to collect and remit tax, they often take the position that the employer is the end user and impose the sales or use tax collection obligation on it. Physical presence presents no hurdle in that context, and the employer would easily have the resources to pay the sales or use tax. Although sales and use tax issues will not prevent any employer from using an award program, it is important for the incentive company and the employer/client to identify this issue in advance and ensure that they reach an agreement in advance with respect to sales and use tax collection and payment.