

## **I Won! Now How Much Do I Owe? How Prize and Award Winnings Can Impact Your Taxes**

In the era of reality TV, aspiring entertainers often look to talent competitions to gain renown, visibility, and of course, the cash prize that comes with winning. In fact, a variety of industries and academic disciplines offer prizes and awards through competitions that may or may not be widely publicized. Whether the contest is associated with the winner's main profession or not, the question that comes around every tax season is whether competition prizes and awards are taxable. The answer is more nuanced than a simple "yes" or "no." The taxes a competition winner must pay depends on a number of factors, such as the conditions under which the prize or award is received and what is done with the earnings. This is where **the help of a Certified Tax Planner is essential to identify tax planning and savings opportunities.**

### **COULD YOUR PRIZE OR AWARD BE TAX-FREE?**

Prizes and awards are not specifically defined in the IRS tax code, but they are referenced in Internal Revenue Code (IRC) section 74 and associated regulations. **A taxpayer's gross income includes amounts received as prizes and awards, but a broad number of exceptions apply.** For instance, qualified scholarships and fellowship grants used to cover tuition and related expenses are not considered taxable income (under IRC §117). Other exclusions include certain prizes and awards transferred to charities, employee achievement awards, and Olympic and Paralympic medals and prizes.

Overall, once these exclusions are taken into consideration, most prizes and awards still fall under the category of taxable income. Some taxpayers may be tempted to designate these proceeds as non-taxable gifts, but **a competition-based prize is unlikely to meet the definition of a "gift."** According to a [Supreme Court Case ruling](#), a gift must proceed "from a 'detached and disinterested generosity...' out of affection, respect, admiration, charity, or like impulses."

The tax implications of a prize or award can also depend on how it was received and how the funds are used. Prizes and awards also differ in their mode of receipt. Some involve an extensive application or audition process, while others have no formal application and may even come as a surprise to the recipient—think of the MacArthur "Genius Grant." Some have specific parameters or "strings attached" to the winnings, but others have no restrictions or guidance on how the money can be used. Similarly, a contest winner who receives an unrestricted cash prize may choose to donate that money to charity, place it in a trust, or take another action that could change the tax consequences.

For example, under IRC §74, a prize or award qualifies as tax-exempt if it is made in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, the recipient took no actions to enter the contest, the recipient is not required to render substantial future services as a condition for the prize, and the prize is transferred to a governmental unit or

organization as a charitable contribution. This was the case with former President Barack Obama who donated his \$1.4 million Nobel Peace Prize winnings to 10 different charities.

## PREPARING TO REPORT A PRIZE ON YOUR RETURN

For those who do not fit the exceptions described above, prize winners should expect to be liable for some amount of tax. **A Certified Tax Planner can assist you** in accurately and completely reporting these earnings as income and using every lawful method to ensure you pay the lowest possible tax.

Assuming that the taxpayer received a taxable prize of cash, property, goods, or services with a readily determined fair market value (FMV), here are some basic questions to evaluate your situation:

- **How much taxable income did the prize provide?** Sometimes the winner will receive a 1099-MISC stating the compensation amount, but sometimes this is absent. Recipients should ask the organization administering the prize about the reportable amount.
- **When will the prize money or other winnings be received?** Some prizes are paid out across multiple tax years. If a taxpayer receives \$625,000 from the MacArthur Foundation, that amount may be paid out ratably over five years.
- **Is the prize money contingent on any incomplete action?** Some awards require the recipient to meet certain conditions or render a service before receiving their winnings.
- **Are there any restrictions or requirements?** Did our winner pay other contractors so that they now have a 1099-NEC or 1099-MISC filing requirement?

In addition to understanding the basics, the taxpayer will also want to determine if the prize counts as self-employment income. Generally, self-employment tax applies to net earnings from a trade or business, and both gross income and related expenses should be reported on Schedule C (or Schedule F for a farm). If a taxpayer is in the business of entering and winning competitions, the IRS could make this argument. However, **prizes and awards are not typically compensation for goods and services and therefore would not count as regular income.**

On the other hand, could prize winnings be considered hobby income? IRC §183 discusses activities not carried on for profit, which do not qualify for tax deductions due to loss of income. Though not officially authoritative, the IRS revised Audit Technique Guide Publication 5558 (9-2021) serves as a handy point-of-reference. The purpose of this guide is to help IRS agents conduct “hobby loss” audits to determine whether taxpayers can deduct losses (trade or business) or not (hobby)—taxpayers can consult this IRS playbook and their collective research as a guide on what is likely fair to claim on their tax return.

## HOW TO REPORT PRIZE-RELATED INCOME

Taxpayers filing a 1040 form can use the “Other Income” line flowing from Schedule 1. For 2021, the IRS expands Schedule 1 line 8 to include subcategories a-z (skipping from r-z) with Prizes and awards on line 8h.

Where can taxpayers deduct any relevant expenses? Artists often use their prize winnings to launch new projects and therefore have expenses to deduct against the prize income. After the Tax Cuts and Jobs Act (TCJA) of 2017, most of the miscellaneous Schedule A deductions were eliminated. However, one promising ruling occurred in the case of *Jorge Quintanilla v. Commissioner* (TC Memo 2016-5). The US Tax Court determined that the taxpayer (a stage technician) could **deduct his business expenses on Schedule C even though the bulk of his income came from W-2/union contracts**. Judge Holmes states: “The big issue is whether Quintanilla correctly reported his business expenses on Schedule C (the schedule that people who are in business for themselves use to report their expenses) and not on Schedule A (the schedule that people who work for somebody else use to report business expenses). The distinction matters because the Code limits Schedule A deductions more than limits Schedule C deductions.” This ruling is especially significant since TCJA eliminated the miscellaneous itemized deduction option.

To take an example of how this ruling might be applied, let’s say there is a composer who enters her work in a competition and wins \$70,000. The competition does not restrict how or when she can use the funds, so in the same tax year, the composer uses \$35,000 to finance a new project. She hires musicians, engages a publicist, rents a concert venue, and pays for catering and other services related to the performance. The composer reports the \$70,000 as “Other Income” and deducts the \$35,000 spent as Schedule C business expenses, thus reducing her net profit and associated self-employment tax. Reporting Schedule C expenses effectively reduces the composer’s overall tax liability.

### SUMMARY

Competition winners benefit from an income boost, as well as the acclaim and opportunities that come with public recognition of their talents. To ensure as much of a profit as possible, prize recipients need to be aware of the tax implications of a sudden influx of cash or other winnings. Focus on celebrating your accomplishments and **leave the tax planning to the experts by contacting a Certified Tax Planner today.**