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THE NEW FRINGE BENEFIT LEGISLATION: A CODIFICATION OF HISTORICAL INEQUITIES

Wendy Gerzog Shaller*

When Representative Fortney (Pete) Stark announced the hearing on the pending fringe benefit legislation,¹ he stated that the bill was intended to present a permanent solution to the inequitable treatment given cash and noncash (or in-kind) compensation. He suggested that the absence of definitive rules governing nonstatutory fringe benefits had led to "uncertainty and inconsistencies in the current administration of tax laws . . . ."² However, the fringe benefit provisions of the Tax Reform Act of 1984 (1984 Tax Act or Tax Reform Act) fall short of accomplishing these goals. Instead, the new provisions have merely concretized some of the historical inequities between cash and noncash compensation while continuing to erode the tax base.³

The 1984 Tax Act excludes from gross income "any fringe benefit which qualifies as a (1) no-additional-cost service, (2) qualified employee discount, (3) working condition fringe or (4) de minimis fringe."⁴ Additionally, the Tax Reform Act amends section 117 of the Internal Revenue Code (Code) to allow for an exclusion for qualified tuition reductions granted to employees of educational institutions.⁵

A no-additional-cost service is defined as an employer-provided service that is available to customers in the ordinary course of the employer's business, without costing the employer substantial additional revenue (including

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⁵. Id. § 117(d).
A qualified employee discount entitles employees to a discount below customer cost on “qualified property or services” (that is, services or property, other than real property or investment personality, that is offered to customers in the employer's ordinary line of business). The price offered to employees must not be in excess of the gross profit percentage of the publicly offered price for property or twenty percent of the publicly offered price for services. The no-additional-cost services and qualified employee discounts are subject to a nondiscrimination rule; the working condition and de minimis fringe exclusions, however, generally are not. A working condition fringe benefit is any employer-provided property or service which, if paid for by the employee, would be deductible as an ordinary and necessary business expense. A de minimis fringe benefit is one that has such insignificant value (taking into account the frequency the benefit is offered by the employer) that accounting for it is unreasonable and administratively impractical. With the exception of subsidized eating facilities, a de minimis fringe benefit is not subject to the nondiscrimination requirement.

Admittedly, both working condition fringe benefits and de minimis fringe benefits may be justified on the ground of administrative convenience; they add to the simplification of the tax laws and do not produce inequitable results. A working condition fringe, for example, substitutes an exclusion for what would have been an inclusion and a matching business deduction under previous tax law.

With respect to no-additional-cost services and qualified employee discounts, however, Congress has added simplicity at the price of eroding the tax base and codifying favoritism to specific industries. Congress has historically ruled that fringe benefits of minimal cost are excludable. Historically, the Internal Revenue Service (Service) has ruled that hams, turkeys, etc. distributed to employees are nontaxable income.
cally shown partiality to certain businesses (for example, the insurance\textsuperscript{15} and housing industries\textsuperscript{16}), for arguably legitimate public interest purposes. By contrast, in the Tax Reform Act, Congress has shown a preference for the airline, university, and retail establishment industries for no apparent reason. Employees in these businesses can take a large percentage of their income in the form of nontaxable fringe benefits and thereby shift the cost of these benefits to all other taxpayers by way of higher taxes on their taxable income.\textsuperscript{17}

In the past, the Internal Revenue Service (Service) and courts have fairly consistently characterized noncash payments to executives as taxable income.\textsuperscript{18} Congress has now chosen to underscore the tax consequences of these discriminatory fringe benefits by codifying the historically inequitable and theoretically unjustifiable exclusions of no-additional-cost services and employee discounts. The primary examples of these new statutory exclusions are airline passes, free tuition, and merchandise discounts.\textsuperscript{19} Sears, Roebuck, and Company, a major retailer, estimates that in 1982 its employee discount amounted to eighty-three million dollars.\textsuperscript{20} Airline passes may well amount to thousands of dollars per employee.\textsuperscript{21} College tuition for two children could easily constitute an $18,000 fringe benefit for a faculty

\begin{itemize}
  \item \textsuperscript{15} See id. § 101(a)(1) (1984) (insurance death benefit exclusion); id. § 101(b) ($5,000 employee death benefit exclusion); id. § 101(d) (special annual interest exclusion for life insurance proceeds paid in installments); id. § 104 (exclusion for insurance payments for personal injury or sickness); id. § 79 (exclusion for the employer-paid expense for the first $50,000 of group-term life insurance).
  \item \textsuperscript{16} See id. § 163 (1984) (deduction for mortgage payments); id. § 1034 (rollover of gain provisions on the sale of one's principal residence); id. § 121 ($125,000 lifetime exclusion of gain on sale of one's personal residence for taxpayers over 55 years old); id. §§ 167, 168 (benefits given owners of residential rental property, particularly for low-income-housing units, and special deductions for the rehabilitation of old property); id. § 1050 (limited recapture provision).
  \item \textsuperscript{17} See \textit{Frayed at the Fringes}, supra note 3.
  \item \textsuperscript{18} See, e.g., United Aniline Co. v. Commissioner, 316 F.2d 701 (1st Cir. 1963) (president and principal stockholder's personal use of corporate yacht constitutes income to him); International Artists, Ltd. v. Commissioner, 55 T.C. 94 (1970) (taxpayer Liberace's personal use of corporate house and furnishing constitutes taxable income equal to an allocable portion of the fair rental value of the property); Rev. Rul. 13, 1973-1 C.B. 42 (financial counseling expenses paid by corporation for its executives are taxable income).
  \item \textsuperscript{19} See \textit{1983 Hearings}, supra note 2, at 8 (statement of Hon. John E. Chapoton, Asst. Secretary (Tax Policy), Department of the Treasury).
  \item \textsuperscript{20} See \textit{1983 Hearings}, supra note 2, at 198 (statement of William E. Sanders, Vice President, Personnel, Sears, Roebuck & Co.).
  \item \textsuperscript{21} Certainly, if an airline employee, accompanied by his/her spouse and two children, takes several trips each year, the employee receives a fringe benefit exceeding $1,000; for the frequent traveler, the benefit could well amount to more than $10,000, particularly for an employee of an international airline.
\end{itemize}
It is true that the Tax Reform Act, in affirming the exemption given to historically tax free benefits, affixed a nondiscrimination requirement to their exclusion. The exclusion does not apply to noncash benefits that are discriminatory (that is, available only to executives or highly compensated employees). A tax free benefit must be available to a reasonable classification of employees and not discriminate in favor of those at the top.\(^{23}\)

Historically, tax free benefits have been justified on the basis that they reflect some noncompensatory business motivation on the part of employers to familiarize their employees with their goods and services.\(^{24}\) There is no sufficient social policy, however, to justify the erosion of the tax base by excluding these now statutory fringe benefits.\(^{25}\) If these benefits have a significant valid business purpose apart from providing additional compensation, they would qualify under working condition exclusions. On the other hand, if their value were truly insignificant, exclusion would be allowed as a de minimis fringe benefit. The exclusion of these benefits, unfortunately, seems more the result of lobbying efforts by special interest groups,\(^{26}\) and a general feeling that the employees are middle class and "they do not have the tax shelters of the rich..."\(^{27}\)

In addition to codifying historical inequities, Congress has effectively created a new index for the determination of taxable income. By instituting a no-additional-cost standard, Congress is shifting its attention from what the employee receives to the employer's expenditure in order to determine the extent to which the employee is enriched. Prior to the fringe benefit legislation, the Internal Revenue Code was clear: "Gross income means all income from whatever source derived..."\(^{28}\) Previously, any examination of employer cost served merely to facilitate the determination of value to the tax-

\(^{22}\) Examples of tuition costs for the 1984-85 school year reveal this fact: Amherst College, $8,911; Harvard University, $9,660; Stanford University, $9,027; Rutgers University, $1,854 (for state residents); State University of New York (Binghamton), $1,496; University of California (Berkeley), $1,361. See Barron's Profiles of American Colleges (14th ed. 1984).


\(^{25}\) See 1983 Hearings, supra note 2, at 7-8 (statement of Hon. John E. Chapoton, Asst. Secretary (Tax Policy), Department of the Treasury); 1983 H.R. Rep., supra note 8, at 305 (noting the new fringe benefit legislation will not result in any additional revenue).

\(^{26}\) See Frayed at the Fringes, supra note 3 (observation that both the President and Congress tried to avoid taxing historically tax free benefits). See also Daily Tax Rep. (BNA) No. 164, at G-2 (Aug. 23, 1983).


Now, integral to the test of exclusion for certain fringe benefits is
the employer's expense and not the employee's income. This new attention
is a theoretical departure from general taxing principles without explanation
for this sudden change in policy.

I. THE SERVICE'S HISTORICAL ROLE

Much of the blame for the inequity and theoretical innovation belongs to
the Service. Historically, it has provided little consistency in its approach to
in-kind compensation.

In 1921, the Service ruled that free railroad passes to employees were non-
taxable gifts. After World War II, when airplanes became the common
mode of travel, airline employees were not taxed on the passes afforded them
and their families. In *Commissioner v. Duberstein*, the Supreme Court dis-
tinguished compensation from a nontaxable gift, requiring that the latter be
made from a "detached or disinterested generosity." Following this deci-
sion, instead of reversing its earlier position in the 1921 revenue ruling, the
Service continued to exclude railroad and airline employee passes from in-
come. Yet, under *Duberstein*, these passes cannot be considered gifts and are
clearly compensation.

Similarly, the regulations promulgated by the Secretary of the Treasury in
1956 excluded, as scholarship, tuition remitted by any participating educa-
tional institution because the student was a child of a faculty member. Yet, in 1969, the United States Supreme Court in *Bingler v. Johnson*,
distinguished compensation from scholarship by defining scholarships as "rela-
tively disinterested, no strings educational grants, with no requirements of
any substantial quid pro quo from the recipient." Applying the *Johnson*
criteria to tuition benefits, the Service certainly could have taxed tuition re-
mission benefits as compensation to faculty members.

In 1975, the Service issued proposed regulations that allowed an em-
ployer to provide all employees those fringe benefits in its line of business
that did not effect additional costs to the employer. The example given in
the proposed regulations was free standby travel for airline employees.
the end of the following year, however, these proposed regulations were withdrawn due to public criticism.\textsuperscript{37} It is curious that the Service made this proposal to exempt no additional-cost-services despite the \textit{Duberstein} and \textit{Johnson} decisions.

Subsequently, in November 1976, the Service singled out tuition remission benefits for professors from all fringe benefits, and announced that these benefits were taxable compensation instead of scholarships.\textsuperscript{38} Following a public hearing two months later, however, the Service announced that this proposed change in the scholarship regulations was being withdrawn.\textsuperscript{39}

A major shift in the Service's attitude occurred in January 1981, when it announced a revised draft of the fringe benefit regulations under Code section 61.\textsuperscript{40} According to the Service, all fringe benefits, except those relating to working conditions and administrative convenience, were to be characterized as taxable income includible at their fair market value. The first two illustrations of the proposed rules, which pertained to those fringe benefits concerned with gross income derived from the personal use of property, services, or facilities, refer to airline passes and tuition remission:

Example (1). F, a flight attendant in the employ of A, an airline company, and F's spouse decide to spend their 1984 annual vacation in Europe. A has a policy whereby any of its employees, along with members of their immediate families, may take a number of personal flights annually for a nominal charge. F and F's spouse take advantage of this policy and fly to and from Europe. The value of the two round-trip flights, less the nominal charge actually paid, is includable in F's gross income. . . .

Example (2). P, a professor in the employ of U, a university, has a child who will be entering college in September of 1984. U has a policy whereby it remits, pays or reimburses the tuition of any employee, or spouse or child of such employee, who attends that university or any other educational institution that participates in a reciprocal tuition remission plan. If P's child participates in such a plan, the value of the tuition remitted, paid or reimbursed will be includable in P's gross income.\textsuperscript{41}

With respect to employer product discounts, the draft allowed an exclusion based on administrative convenience for a nondiscriminatory, no-additional-
cost discount on a product or service that is available as part of the employer's trade or business. The discount could not exceed the lesser of twenty percent of the public sales price or $100 per item for nonrepetitive items or the lesser of twenty percent of the public sales price or $200 per year for repetitive items.\textsuperscript{42} Pursuant to this provision, airline passes and tuition remission would be taxable only if the discount exceeded the lesser of twenty percent of the public sales price or $100 per item. An example given under these provisions states that a railroad employee who receives a twenty percent discount equal to $100 on a round trip ticket may exclude the discount from his income.\textsuperscript{43} By analogy, the same exclusion is available to an airline employee who is provided the same kind of discount. The proposed regulations are unclear, however, regarding whether and to what extent tuition remissions could qualify as employee discounts.\textsuperscript{44} Furthermore, since the drafted regulations did not include a cap on an employee's total yearly exclusions, an employee could conceivably receive unlimited $100 discounts.

The Service almost immediately hedged its new position that fringe benefits such as airline and railroad passes were taxable. It stated that in determining fair market value for fringe benefits, it would employ a discount valuation rule that would take into account nontransferability, standby status, and the limited choices involved in these benefits. The discount valuation rule would apply only to goods and services produced or used in the ordinary course of the employer's trade or business.\textsuperscript{45}

The need for the discount valuation rule, however, is questionable. While on the one hand, there are limitations on transferability and ability to convert these benefits into cash, on the other hand, these benefits are not purchased with after-tax dollars and many services sold to the public are also subject to similar restrictions. The fact that the employee might not have purchased the product or service without the incentive of the fringe benefit is not a sufficient reason for discounting its value. Making a choice based in part on low cost is an element of the concept of fair market value.

Finally, in the wake of the 1984 tax legislation, the Service issued Revenue Procedure 84-14.\textsuperscript{46} The Service stated that it would refrain from issuing

\textsuperscript{42} Id. § 1.61-19(b)(1).
\textsuperscript{43} See id. § 1.61-19(c), example (3).
\textsuperscript{44} Under Proposed Reg. § 1.117-3(a), tuition remitted on or after January 1, 1984 would be covered by Proposed Regs. §§ 1.61-17 through 1.61-20; however, none of the examples in those subsections refer specifically to tuition remitted to children of faculty members.
fringe benefit rules and regulations until after January 1, 1985.

II. CONGRESS' HISTORICAL ROLE

With the exception of its 1979 Task Force, which offered a discussion draft of fringe benefit legislation, Congress has, until now, been hesitant to enact any legislation on this subject. The 1979 Task Force discussion draft excluded fringe benefits that: were available to at least a reasonable classification of employees; imposed no substantial incremental cost on the employer; and whose total yearly value was insubstantial either in absolute terms or in comparison to the employee's total compensation. Exclusions were also provided for de minimis fringe benefits furnished to facilitate the employee's work, and such other benefits as prescribed by the Secretary in his regulations. Any other fringe benefit would be taxable and includible at its fair market value less any consideration furnished by the employee. Although more vague and therefore more difficult to apply than the 1984 tax legislation, the 1979 discussion draft is similar in many ways. The 1984 Tax Act, however, does not provide a ceiling on the total amount of nontaxable fringe benefits an employee may receive.

Congress has recognized both the unpopularity of taxing tax-free benefits ("the great public and professional concern") and its primary responsibility of legislating tax policy. Legislation prohibiting the Treasury Department from issuing final regulations relating to fringe benefits was first enacted prior to 1980, then prior to June 1, 1981, and finally prior to December 31, 1983.

The Tax Reform Act essentially codifies the existing "perception and expectation" that fringe benefits are not taxable income. It also perpetuates the inequitable treatment accorded to (1) university and preparatory school families who receive tuition remission benefits tax free as opposed to the taxable or restricted educational benefits offered by nonschool employers.

47. HOUSE WAYS AND MEANS COMM. TASK FORCE ON EMPLOYEE FRINGE BENEFITS, HOUSE COMM. ON WAYS AND MEANS, 96TH CONG., 1ST SESS. (1979), reprinted in 57 TAXES 284, app. A (May 1979) [hereinafter cited as 1979 DISCUSSION DRAFT].
48. Id. at Prop. § 84(b).
49. Id. at Prop. § 84(c).
50. Id. at Prop. § 84(e)(2).
and (2) airline industry families who receive tax free passes, unlike employees of other industries who receive taxable bonuses, awards, or tip income. Finally, the no-additional-cost criterion changes the focus from the taxpayer’s income to the employer’s cost in order to determine the taxpayer’s taxable income.

III. DISPARATE TREATMENT FOR DISPARATE INDUSTRIES

A. Education Expenses

The 1984 Tax Act amends Code section 117 to allow a current, retired, or disabled employee of an educational institution to exclude tuition remission, or cash grants, from his income. These benefits may be applied to elementary, secondary, or undergraduate education programs at the employee’s school or any other educational institution that maintains a reciprocal agreement with that school as long as the tuition remission benefits are provided on a nondiscriminatory basis. This fringe benefit afforded to school personnel and their families may be contrasted to the more limited provision offered nonschool employees under a qualified plan or the job related requirements affixed to the deductibility of educational expenses for all other nonschool employees whose employer has not implemented such a program.

On October 11, 1984, Congress revived, modified, and extended a limited exclusion previously available for tax years 1979 through 1983 until the end of 1985. This exclusion is available to employees whose employer has established a separate, written nondiscriminatory plan. The statute excludes from taxation amounts furnished to an employee under a qualified plan even


61. H.R. 2568, passed by the 98th Congress and sent to the President on October 11, 1984, repealed the provision that terminated the educational assistance plan exclusion at the end of 1983. The new law also removed the penalties on employees who did not withhold payroll and income taxes on tuition payments after 1983. Finally H.R. 2568 required annual information returns by employees with respect to these benefits.

Earlier in 1984, when the fringe benefit exclusion for school employees was passed, it appeared to come simultaneously with the demise of I.R.C. § 127. See 1984 Conference Report, supra note 11, at 1180. The Senate had proposed a two-year extension to the exclusion for educational assistance benefits, but the conference agreement deleted the Senate amendment. Id. See 24 TAX NOTES 1215 (1984) (for a synopsis of the alternative modifications that were suggested for the education assistance exclusion).
if these amounts do not meet the tests for deductibility of educational expenses under treasury regulation section 1.162-5. This "off-again, on-again" provision was enacted to erase the purportedly ambiguous and inequitable restrictions in the regulations that stated an employee may not deduct the cost of a course unless the course maintains or improves skills required by the individual in his employment.\(^6\) The regulation was deemed especially disadvantageous to lower level employees.\(^6\) When this provision was restored and extended through 1985, Congress attached a $5,000 per year cap on the exclusion. While admittedly ineffective\(^6\) as a means of preventing the erosion of the tax base, the placement of any ceiling on these benefits distinguishes them from the unlimited benefits of qualified tuition reductions.\(^6\) Unlike the 1984 fringe benefit exclusion available to school employees, the benefit offered by the educational assistance statute does not include tuition remission of an employee's spouse or child.\(^6\)

Except for employees of an educational institution, and except for the temporary section 127 exclusion, such benefits have consistently been held to be taxable compensation.\(^6\) In Johnson,\(^6\) the Supreme Court upheld the validity of treasury regulation section 1.117-4(c) that denies application of the scholarship exclusion where the tuition remission represents "compensation for past, present, or future services."\(^6\) Similarly, in Armantrout v. Commissioner,\(^6\) the Tax Court held that key employees whose children received funds to defray college costs were taxable on these amounts under both Code

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\(^6\)S. REP. NO. 1263, 95th Cong., 2d Sess. 100-01 (1978). Ironically, it is the typically lower paid employees of smaller businesses whose employer has not instituted a plan under § 127 who are subject to the confinements of the regulation.
\(^6\)See, e.g., Kreiser, A New Standard for Determining the Tax Treatment of Nonstatutory Employee Fringe Benefits, 7 REV. OF TAX’N OF INDIVIDUALS 158 (1983). Although it has been suggested that a similar ceiling be applied to all tax free fringe benefits, the imposition of a cap does not prevent the erosion of the tax base and erase inequalities. If fringes are de minimis, they will be excluded as de minimis fringe benefits; if they are substantial, they should be taxed.

\(^6\)Where an employer, however, has an independently administered scholarship program, a scholarship awarded on a competitive basis to an employee's child is not includable income. See Chase v. Commissioner, 29 T.C.M. (P-H) 265 (1960) (where the court held that because all scholarship recipients were employees and not required to continue their employment, the awards were not given to further a business purpose).

\(^6\)See, e.g., Rev. Rul. 484, 1957-2 C.B. 113 (where the Service ruled that employer's reimbursement of educational expenses constitutes additional income to the employee). The expenses, however, may be deductible if they comply with the requirements of Treas. Regs. § 1.162-5 (1984).


\(^6\)Id. at 751.

\(^6\)67 T.C. 996 (1977), aff'd per curiam, 570 F.2d 210 (7th Cir. 1978).
sections 61 and 83 because these benefits were based on the employees' performance of services for their employer.\textsuperscript{71}

Although there appears to be no rational basis for this disparate treatment accorded faculty families and all other employees and their families with regard to tuition remission, a major argument for the distinction has been that tax free tuition remission for faculty families has allowed educational institutions to retain highly qualified faculty without additional cost to the institutions. Yet, even if a faculty member in the twenty to thirty percent bracket is taxed for these benefits, he is still getting an enormous discount on his child's tuition. For example, a faculty member could receive a $5,000 tuition remission by paying only $1,000 to $1,500 to the Federal government in taxes;\textsuperscript{72} most other parents of students, however, are paying the full $5,000 tuition and with after-tax dollars. Moreover, not all faculty members have families who take advantage of these benefits. Finally, faculty members, like any other employees, who take courses themselves could exclude the cost of these courses as a working condition fringe benefit where, if the employee had paid for this service, he could have deducted its cost under treasury regulation section 1.162-5 (after including the remission as income). If, however, the classes selected do not constitute a working condition fringe benefit, faculty members and other university employees, like their families, would still receive a bargain on the cost of their classes since they are only paying taxes on this benefit. There is no problem with valuing tuition remission because the tuition is easily reduced to a cash value; the new legislation even excludes "cash grants" that clearly reflect a specific cash value.

Before the 1984 legislation was modified to include tax free treatment of tuition benefits where an employee's institution had written a reciprocal agreement with another institution, a representative of the American Association of University Professors charged that without such tax free tuition remission treatment, a faculty child's choice of educational institutions would be restricted. In the absence of the modification, he asserted that the provision would discriminate against those faculty children who did not qualify for admission to their parent's institution.\textsuperscript{73} It is difficult, however, to understand how tuition remission for unqualified students is classified as "scholarship" rather than additional compensation. In addition, such limi-

\textsuperscript{71} Id. at 1007 n.4. Rev. Rul. 448, 1975-2 C.B. 55, states that where an employer makes available benefits under an educational benefit trust, provided the parent is a current employee, when the child is eligible for benefits, the parent/employee has additional includible income at the time of such vesting.

\textsuperscript{72} It would be difficult to accept the premise that a university could not retain a faculty member in the 50\% tax bracket without such tax-free fringe benefits.

\textsuperscript{73} 1983 Hearings, supra note 2, at 173-77 (statement of Prof. William Collins).
tations of choice placed on the children of faculty members do not reduce the value of tuition remission benefits since many factors, including relative cost, create limitations of choice for all students.

Unlike the broad exclusion for qualified tuition reduction benefits, limitations are imposed on the educational assistance programs. Furthermore, an employee working for a company not offering such a plan is restricted to the deduction provided by treasury regulation section 1.162-5. There is no justification for the 1984 tax legislation that excludes tuition remission for both the faculty member and his family at both the faculty member’s institution and any other institution with a written reciprocal agreement.

B. Valuation Problems: The Airline Employee Versus The Prize Winner

The Service’s 1921 rationale for excluding travel passes to transportation employees from taxable income was that the passes constituted nontaxable gifts. As a result of congressional inaction, such passes continued not to be taxed; now, the Tax Reform Act has secured tax free status for these fringe benefits.

It is unclear why Congress has conferred this tax benefit particularly upon airline industry employees. Proponents of the legislation assert that without the tax free status of airline passes there would be valuation and other administrative difficulties. For example, “[h]ow much is the flight worth when the airline employee may have to wait as long as 48 hours to get on an open flight?” It is argued that it would be “economically unrealistic” to

74. O.D. 946, 4 C.B. 110 (1921) (railroad passes given to employees are nontaxable gifts).
75. Congress has, for instance, chosen to follow a different tack with respect to prize winners, whose income was also considered at one time to be nontaxable gifts. See, e.g., McDermott v. Commissioner, 150 F.2d 585 (D.C. Cir. 1945) (prizes awarded in a contest motivated by charitable or educational purposes were considered gifts); Campello v. Commissioner, 24 T.C. 372 (1955) (prizes awarded where the winner did nothing to receive the prize were deemed gifts); Washburn v. Commissioner, 5 T.C. 1333 (1945). In response to these and other cases holding that prizes constituted nontaxable gifts, Congress added § 74 to the 1954 Code. See S. Rep. No. 1622, 83d Cong., 2d Sess. 13, 178 (1954), reprinted in 1954 U.S. Code Cong. & Ad. News 4621, 4813. Since enactment of § 74, courts have rejected the gift theory for prizes and awards. See, e.g., Simmons v. United States, 197 F. Supp. 673 (D. Md. 1961), aff’d, 308 F.2d 160 (4th Cir. 1962); Hornung v. Commissioner, 47 T.C. 428 (1967).

Of course, prizes and awards given to employees for special achievement have almost always been treated as taxable income. See, e.g., Griggs v. United States, 314 F.2d 515 (Ct. Cl. 1963). Moreover, in Robertson v. United States, 343 U.S. 711 (1952), the Supreme Court held that if a prize was awarded pursuant to an enforceable contract obligation, this discharge of a legal obligation was not a gift, but income. But see Jones v. Commissioner, 743 F.2d 1429 (9th Cir. 1984), rev’g 79 T.C. 1008 (1982).
77. 1983 Hearings, supra note 2, at 143-44 (statement of Linda A. Puchala, President, Association Flight Attendants, AFL-CIO).
assume that the employee would pay the fair market value for these benefits.\textsuperscript{78} In addition, varieties of standby travel, priorities, and classes of service would have to be considered in placing any value on the benefits.\textsuperscript{79}

These same concerns, however, have not prevented prize winners, for instance, from being taxed on their winnings.\textsuperscript{80} Valuation problems occurring with respect to prizes awarded in-kind have been resolved. For example, when a taxpayer won steamship tickets valued at their fair market value\textsuperscript{81} on a radio program, a court held they were taxable at approximately two-thirds of their retail cost because they were nontransferable and subject to other use restrictions.\textsuperscript{82} Similarly, where an employee won an automobile which, after 10 days of use, he traded for another vehicle plus $1,000 in cash, he was taxed on $3,900 (the dealer’s cost for the vehicle received in the trade, plus the cash and rental value of the automobile for its ten days of use) rather than $4,453 (the employer’s cost for the car).\textsuperscript{83}

Special airfares sold to the public contain many restrictions on their transferability and use. Airline passes containing similar limitations could possibly be valued at the lowest monthly cost for standby tickets or at the rate other restrictive low fare tickets are sold to the public. Certainly, valuation problems of airline passes are no more difficult than the valuation of prizes received in-kind. Moreover, even under the Tax Reform Act, airline passes must be valued since passes issued to an employee’s parents (as opposed to his spouse, his child, or himself) are taxable fringe benefits valued at their fair market value.

C. Accounting Burden: The Airline Industry Versus The Restaurant Industry

Despite the certain gift-like attributes of tips and the administrative inconvenience to restaurant owners/employers, tip income constitutes gross income to the employee and requires additional bookkeeping and reporting by the employer. Congress and the courts have consistently treated tips received by waiters and taxicab drivers, and “tokes” received by casino dealers, as taxable income.\textsuperscript{84} Despite the gratuitous element in tips or tokes,
these amounts are not considered gifts because they are given in response to services rendered and clearly enrich the recipient. Although tokes are given spontaneously, they do not proceed from a "detached and disinterested generosity." Like airline passes, tips provide a clear economic benefit to employees; yet, the Tax Reform Act treats airline passes as excludible income.

Under the authority of Code section 446(b), if a taxpayer has not kept a record of his income, the Commissioner may compute taxable income under a method he deems reflective of such income. This idea of a forced computation was recently imposed on restaurant employees despite great industry opposition. As of April 1, 1983, if the total reported tips for any payroll period are less than eight percent of gross receipts for that period, the restaurant must allocate the difference among employees, and report this amount to the Secretary annually. The employee must be furnished with a statement showing the amount of tips that were thereby allocated to him. Employers of "large food or beverage establishments" must additionally report to the Secretary certain information regarding gross receipts, charge receipts and charged tips, and tips reported to them. The 1984 Act provides that either a majority of employees or an employer may petition the Secretary to reduce the percentage to be allocated, but not below two percent.

There is no reason to distinguish between the restaurant and airline industries on the matter of administrative inconvenience. It would not be more inconvenient to require the airline industry to keep records of its employees' pass requests than for a large food or beverage establishment to keep track of its employees' tips.

85. Olk v. United States, 536 F.2d at 877-78 (citing Commissioner v. Duberstein, 363 U.S. 278, 285-86 (1960)).
89. A large food or beverage establishment is defined as one that normally employs more than 10 employees who customarily receive tips for serving food or beverages. I.R.C. § 6053(c)(4) (1982). For tax years following 1982, an individual owning 50% or more of the corporation operating the establishment is not an employee for the above purpose. 1984 Tax Act, supra note 1, at § 1072.
91. 1984 Tax Act, supra note 1, at § 1072 (effective for years after December 31, 1982).
IV. QUALIFICATIONS FOR EXCLUSION?

A. No Additional Cost Benefits: Revenue Foregone

Responding to criticism that "revenue foregone" be included in determining whether a fringe benefit is "no-additional-cost," the lawmakers included any revenue foregone because the employer provided the service to the employee rather than a customer in the definition of "cost." Yet, immediately after stating this requirement, the House Report explains that no additional cost is incurred because, for example, employees fill otherwise empty seats on airplanes and trains. Interestingly, Congress admits that revenue foregone is an element of cost, but has not conditioned the exclusion of free airline passes to employees on the requirement that employers first offer the seats on a standby basis at low cost to the public. Judging from the success of low cost airfares and airlines resulting from deregulation, there is no sound basis for the proposition that free passes to standby employees do not effect a revenue loss to their employers. Thus, it appears that "revenue foregone" has little meaning in the statute.

B. Line of Business Limitation

One purported reason for the fringe benefit legislation is the recognition that employers have business reasons for offering employees free or discounted products that are sold to the public. Essentially, when employers provide no-additional-cost services or qualified employee discounts, they want their employees to familiarize themselves with the goods or services. If business reasons are paramount, these fringe benefits could be excludible from income as working condition fringe benefits (that is, if they meet the ordinary and necessary requirements of all business deductions). It is questionable, however, that the business motive of acquainting the employee with the employer's products will be sufficient to constitute a working condition fringe benefit where the employee might also have a personal reason for using the product or service. For example, in Pevsner v. Commissioner, the

\[\text{I.R.C. § 132(b)(2) (1984); see 1983 H.R. Rep., supra note 8, at 289.}\]
\[\text{1983 H.R. Rep., supra note 8, at 289.}\]
\[\text{See, e.g., People Express to Start Service to Los Angeles: United Matches Fare, Wall St. J., June 8, 1984, at 4, col. 4; Salpulkas, People Express Sets New, Cut Rate Coast Flights, N.Y. Times, June 8, 1984, at D6, col. 1.}\]
\[\text{See 1983 H.R. Rep., supra note 8, at 286.}\]
\[\text{628 F.2d 467 (5th Cir. 1980), rev'g 38 T.C.M. (CCH) 1221 (1979). The taxability of the discount the employee received on the clothing was not an issue here.}\]
United States Court of Appeals for the Fifth Circuit denied a deduction to a boutique manager for the cost and maintenance of the Yves St. Laurent clothes and accessories that she was required to wear by her employer. The Court found that her clothing was objectively adaptable for personal use.\textsuperscript{99}

In addition, the mixed business/personal rationale does not explain why the 1984 legislation includes those discounts offered to the employee's spouse and dependent children, widow(er)s of former employees, and retired employees and their families as nontaxable fringe benefits.\textsuperscript{100} They do not need to be familiar with the employer's products or services. In fact, this exclusion is contrary to the requirement that the taxpayer's family have a significant bona fide business purpose for incurring expenses when claiming a business deduction ordinarily available only to the employee.\textsuperscript{101} It is also difficult to appreciate how this business purpose rationale applies to free passes or discounts occasioned by reciprocal arrangements between often times rival, or at least competitive, companies.\textsuperscript{102}

Finally, the taxation of fringe benefits does not mean that employees will have to pay for presently free or discounted products or services in the same way that the public must buy these products or services with after-tax dollars. The employee may continue to receive valuable benefits from his employer, but will be taxed on these benefits. If, for example, an airline employee in the thirty percent tax bracket receives a free pass worth a minimum of $500 to the public, he will pay $150 to the federal government for a $500 ticket. Given the savings of $350, most employees will continue to take advantage of this benefit and will familiarize themselves with the employer's service. Similarly, a thirty percent bracket employee offered a twenty percent discount on merchandise costing $1,000, will pay a tax of only $60 on a $200 benefit, resulting in an effective price reduction of $140. The issue then, is not whether employees should be allowed free or discounted benefits, but whether Congress equitably decided to exclude these benefits from taxation.

\textsuperscript{99} 682 F.2d at 470-71.
\textsuperscript{101} See Treas. Reg. § 1.162-2(c) (1984), requiring that a taxpayer's spouse or other family member who accompanies the taxpayer on a business trip show a bona fide business purpose in order to deduct those expenses.
\textsuperscript{102} See 1984 Tax Act, supra note 1, at § 1072 (to be codified at 26 U.S.C. § 132(g)(2)). As originally written, the fringe benefit exclusion did not extend to reciprocal agreements between employers. Compare 1984 Tax Act, supra note 1 (present law) with 1983 Hearings, supra note 2, at 15-30 (H.R. 3525 as introduced and H.R. 3525 as reported by the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means). H.R. 3525, 98th Cong. 1st Sess. 633-37 (1983). It should be noted that H.R. 3525, which concerned only fringe benefits, was incorporated by the Committee into H.R. 4170, the comprehensive tax reform act reported out on Oct. 5, 1984. See 1983 H.R. REP., supra note 8, at 11.
V. ADOPTION OF A NEW INDEX

Some commentators have suggested that a benefit loses its nature as compensation where the employer incurs no additional cost in providing the service. This approach, however, views "compensation" from the perspective of the employer, not the employee.

By instituting the no-additional-cost standard for determining income, Congress has for the first time implicitly shifted its focus from the income recipient to the payor. While this standard is descriptive, and thus accommodating, of the former nonstatutory treatment of these fringe benefits, it distorts the traditional theories of taxation.

Prior to the recent legislation, the use of the payor's expense had only been used where it enabled the taxing authorities to establish the best estimate of the fair market value of the benefit received. For example, in United States v. Gotcher, a taxpayer was permitted to exclude the value of a trip to Germany because it served a legitimate business purpose of his employer and the payors. The court found that the value of the trip was equal to the amounts expended by the taxpayer's employer and the other payors.

Generally, the equivalence between an employer's cost deduction and an employee's compensation is fortuitous. Certainly, most compensation is income to the employee and deductible by the employer in the same amounts. As the Supreme Court stated in Duberstein, however, when reviewing the fact that the transferor took a business deduction for the "gift" of a Cadillac to the taxpayer,

it is doubtless relevant to the over-all inference that the transferor treats a payment as a business deduction, or that the transferor is a corporate entity. But these inferences cannot be stated in absolute terms. Neither factor is a shibboleth. The taxing statute does not make nondeductibility by the transferor a condition on the 'gift' exclusion. . . . The conclusion whether a transfer amounts to a 'gift' is one that must be reached on consideration of all the factors.

There is little merit to the contention that the use of a fair market value standard of includibility would destroy "the parallel treatment between the employee and the employer, since the effect would be to impute income to

104. See Note, supra note 92, at 1157.
105. 401 F.2d 118 (5th Cir. 1968).
the employee in excess of that expended by the employer." Rather, there is no reason to require any parallel treatment when income is computed on the sole basis of the benefit to the employee.

There are many instances where such equivalence cannot be found. Since the restauranteur does not pay waiters' tips, he is not allowed a corresponding deduction. The waiter, however, must include this amount as income. The tipper, who may be using these services for personal and not business reasons, also may not be able to take a deduction. With respect to prizes, the recipient must include as income the fair market value of the prize at the date of its acquisition. The corporation providing the prize, however, is limited to a deduction equal to the cost of the prize.

Indeed, many employer deductions are either disallowed or limited by the tax statutes even though the recipient must include a higher, full amount in his income. To be deductible, an expense must be "ordinary and necessary." Amounts paid in excess of reasonable compensation are not deductible. Similarly, amounts paid for certain travel, entertainment and gifts are subject to substantiation and other requirements that may result in their disallowance. Specifically, business gifts are limited to a maximum annual deduction of twenty-five dollars for each recipient. Certain business deductions, such as illegal bribes and kickbacks, fines and penalties, and treble damages from antitrust violations, are subject to disallowance for public policy reasons.

In addition, the requirement of an equivalence has only been found to run the other way around. For example, an employer's deduction will be disallowed until the employee has included the value of stock, given as compensation, in his income. Similarly, a deduction will be disallowed where expenses relating to a deduction are attributable to taxable income.

Finally, the focus on an employer's incremental cost to determine if an

107. 1983 Hearings, supra note 2, at 281 (statement of the Tax Executives Institute, Inc.).
112. See id. § 162(f).
113. See id. § 162(f).
114. See id. § 162(g).
amount constitutes income (instead of on what the employee receives) is admittedly a convenient way of codifying the status quo treatment of fringe benefits. It is not, however, a very useful or equitable measure of taxable income.

VI. SECTION 83

Added by the 1969 Tax Reform Act, Code section 83 was intended to remove the preferential treatment given to restricted stock plans as opposed to other types of deferred compensation and qualified stock options. Prior to the enactment of section 83, an employer could give an employee stock subject to the restriction, for example, that it not be sold within five years. Although the employee could vote the stock and receive dividends, he was not taxed on the receipt of the stock until the restriction expired. Section 83 now requires that the employee be taxed on the value of the property upon receipt, less any amount paid, unless the property is subject to a substantial risk of forfeiture. The employer is allowed a business deduction for the transfer in the year in which the value of such property is included in the employee’s income. Although the statute originally was motivated by a desire specifically to tax stock given to employees in the year of receipt, it applies generally to the transfer of all property in exchange for the performance of services.

Several commentators have suggested that all noncash fringe benefits, except for working condition and de minimis fringe benefits, could be covered by section 83, as well as section 61. Like other in-kind compensation, these fringe benefits, including travel passes and tuition remission benefits, should be includible in income.

VII. CONCLUSION

Rather than reducing the inequitable treatment of in-kind and cash compensation, the Tax Reform Act of 1984 merely codifies the special benefits accorded to noncash compensation given by certain industries to their em-

122. Id. § 83(h).
123. Id. § 83(a); Treas. Reg. § 1.83-3(e) (1984).
ployees. Employees of retail stores receive their discounts tax-free; airline employees enjoy their free passes tax-free; and university employees educate their children at government expense. This erosion of the tax base is difficult to justify. There are no social policy reasons to explain the preferential treatment accorded these employees. If there were significant business reasons to justify the exclusion of these benefits, they would already have been excluded as working condition fringe benefits. If their value were truly small, they would have been excluded as de minimus fringe benefits. Considering the administrative burden placed on the restaurant industry, reinforced by the Tax Reform Act of 1984, to report and, if necessary, to allocate tips among its employees, these fringe benefits cannot be explained in terms of administrative convenience. Finally, because an employer incurs no additional cost (except, of course, "revenue foregone"—a term rendered meaningless by the 1984 Act), there is no merit to the corollary that an employee's benefit is not "compensation." By focusing on the employer's cost rather than on the traditional examination of what the employee receives, Congress is departing from a basic principle of what constitutes taxable income. This departure, again, has no meaningful rationale; it appears to be merely a means of codifying the historical treatment of certain fringe benefits without examining the inequities created by this erosion of the tax base.

Essentially, the exclusions for working condition and de minimus fringe benefits may be justified on the grounds of tax simplification and administrative convenience. The exclusions for no-additional-cost services, qualified employee discounts, and qualified tuition reductions, however, should be repealed.

Although this article focuses on the example of the airline employee, hotel and other transportation employees also receive no—additional—costs fringe benefits.