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FRINGE BENEFITS AND TAX REFORM HISTORICAL BLUNDERS AND A PROPOSAL FOR STRUCTURAL CHANGE

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I. INTRODUCTION

The current state of the law regarding the tax treatment of fringe benefits is confusing. The Internal Revenue Code of 1954 specifically excluded many such items from its definition of income, and administrative actions excluded others. Still, some fringe benefits are included in income, despite the absence of a rational justification for distinguishing them from the excluded benefits. Current law reflects the legislators' continuing failure to develop a coherent fringe benefit policy, a failure which dates back to the inception of the income tax. This article will explore the reasons for the past failure to systematically analyze the fringe benefit problem and will suggest a simple, straightforward solution. The resolution is to follow the principles of section 83 of the Code to tax all fringe benefits to employees.

Issues of this nature must be addressed now, particularly in light of recent developments in Congress. In the Tax Reform Act of 1984,[1] Congress addressed the fringe benefit issue rather thoroughly. Nonetheless, the changes made in the law essentially codified pre-existing administrative exclusions.[2] One significant 1984 reform is the congressional intent to apply anti-discrimination provisions to all fringe benefit programs for an exclusion to be available.[3]

In the main, however, the 1984 legislation does not make a meaningful change in the taxation of this important part of compensation packages. The Treasury apparently believes further reform efforts are needed.[4] Nevertheless, Congress, ever subject to the pressures of lob-

1. Tax Reform Act of 1984, Pub. L. No. 98-369, § 531, 98 Stat. 494, 877 (added the new fringe benefit provisions to the Code).

2. New §§ 117(d) and 132 originated in the "Permanent Tax Treatment of Fringe Benefits Act of 1983," H.R. 3525, 98th Cong., 1st Sess. A major reason for the codification of the rules was that certain practices are "long established, and generally have been treated by employers, employees and the Internal Revenue Service as not giving rise to taxable income." *See* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 840 (Comm. Print 1984) [hereinafter cited as JOINT COMM. ON TAXATION].

3. *See* I.R.C. §§ 132(h)(1), 117(d)(3) (West 1985). *See also* JOINT COMM. ON TAXATION, *supra* note 2, at 861-62. Exceptions to the application of the general nondiscrimination rules are working condition fringes and de minimis fringes other than subsidized eating facilities. In other words, it is perfectly permissible to provide studio executives with corner offices and limousines for use on business trips, without having to provide such amenities to clerical personnel.

4. The Treasury Department's original tax reform proposal would have repealed virtually

byists, has not expressed a clear willingness to work toward such base-broadening reforms.[5] What is clear, however, is that fringe benefits and the problems they create in the tax system will not go away. Therefore, consideration of both the policy and the technical aspects of taxing them remains an important matter for scholarly attention.

Analysis of fringe benefit taxation is important for other reasons as well. Tax reform will likely continue to be a vexing political problem raising the perennial concerns of fairness and equity in the current income tax system.[6] As the Internal Revenue Code of 1954 has grown longer and more riddled with special interest provisions, the question of whether reform of the present system is necessary has been examined with increasing popularity. Although desirable fundamental reform is unlikely to occur, the debates about broadening the tax base and seeking to provide more incentive for saving may well lead to less fundamental structural changes.

One of the most important issues in either the current system or a structurally different system is how to define the tax base. As to inclusion of compensation in the base, the Code currently taxes both wages paid in cash and many forms of compensation paid in-kind. However, not all forms of in-kind compensation are taxed. An understanding of how the current system treats in-kind compensation for the performance of services and why it does so is fundamental to an

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all the current exclusions for fringe benefits. *See* OFFICE OF THE SECRETARY, DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, GROWTH AND SIMPLICITY: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, Vol. 1, at 73-74 & Vol. 2, at 26-55 (1984) [hereinafter cited as TREASURY I]. A comparative analysis of the treatment of fringe benefits under TREASURY I and the modified flat rate income tax bills pending in Congress in the Spring of 1985 can be found in Simon, *Base Broadening Proposals and Fringe Benefits*, 29 ST. LOUIS U.L.J. 1201, 1203-07 (1985).

The President's tax reform proposal retreated from the original Treasury position, and suggested much more moderate reform of the fringe benefit area. *See* THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY, ch. 3 (1985) [hereinafter cited as PRESIDENT'S PROPOSAL]. Although the PRESIDENT'S PROPOSAL would set up a uniform nondiscrimination standard for all fringe benefits, *id.* ¶ 3.04, it would repeal outright only the § 101(a) exclusion for employer-provided death benefits and the exclusion under § 127 for employer-provided transportation. *See id.* ¶¶ 3.02 & .03. As to health benefits, the PRESIDENT'S PROPOSAL stands TREASURY I on its head and asks for the taxation of a certain minimum amount of health benefits rather than taxing benefits provided above a certain cap, as the Treasury had originally suggested. *Compare* 1 TREASURY I, *supra*, at 28-34 *with* PRESIDENT'S PROPOSAL, *supra*, ¶ 3.01.

5. *See, e.g.*, Act of May 24, 1985, Pub. L. No. 99-44, § 1, 99 Stat. 77, 77 (1985) (Congress acted quickly to repeal a contemporaneous recordkeeping requirement in § 274 which had been imposed by the Tax Reform Act of 1984); *Conferees Agree on Bill Repealing Auto Recordkeeping Requirement*, 27 TAX NOTES (TAX ANALYSTS) 565 (May 6, 1985). *See generally* Sheppard, *Tax Reform Redux: The State of the Record*, 28 TAX NOTES (TAX ANALYSTS) 1215 (Sept. 9, 1985) (discussion of the difficulties of base broadening tax reform).

6. The recent spate of tax reform proposals has generated significant debate in the lay press and in scholarly journals as well. *See, e.g.*, Berger, *In Behalf of a Single-Rate Flat Tax*, 29 ST. LOUIS U.L.J. 993 (1985); Simon, *supra* note 4, at 1201.

informed critique of general reform proposals that would alter the tax base or that would move away from taxing income to taxing consumption.[7] It is within that broader perspective that the issues raised in this article with regard to taxing fringe benefits should be considered.

Defining the term "fringe benefit" has proven to be a difficult task. For this article, a broad and widely comprehensive definition was chosen to simplify the point of departure. All benefits, facilities, or services furnished by employers to employees, beyond the bare minimum required for adequate performance of services, will be considered fringe benefits. The term, therefore, includes items such as carpet on the floors, pictures on the walls, and a receptionist to answer the phone. It also includes far more significant items currently excluded from income under various provisions of the Code such as employer-funded health insurance and deferred compensation plans. This article will consider the historical treatment of all forms of fringe benefits under the Internal Revenue Code — from pictures to pensions — as a prelude to a proposed mechanism for determining whether to tax them and how to tax them, in one simple system.[8]

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7. A consumption-type tax system would mandate taxation for certain expenditures and others would be exempted from taxation. If one determined that expenditures for food and lodging, for example, were taxable, then it should be determined whether employer-provided housing, meals and other personal expenditures should be included in the tax base at their fair market value. If certain expenditures such as pension fund investments are deemed tax-exempt, a mechanism is needed to ensure nondiscriminatory application. In other words, the determination of the base and the fringe benefits included in it presents a problem of the same magnitude for a consumption-based system as for an income-based system.

With a pure consumption system, determining the treatment of expenditures by employers for their employees in cases where the expenditures were not tax-favored would also be necessary. For example, under a consumption system, an employer-provided house would presumably be nontaxable if it were business-related compensation. No symmetry problem would arise because such housing would be a nontaxable expenditure at the employer level and a taxable expenditure at the employee level.

To a certain extent, the present system shares features of both consumption and income systems by favoring certain expenditures over others. Pension plan investments provide a clear example of the use of the consumption theory in an income tax context. The proposals made in this article retain that amalgamation for investment in pension plans.

For general discussions of consumption tax proposals, see Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975) [hereinafter cited as Andrews II]; Andrews, *A Consumption Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Warren, *Fairness and Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975). For a discussion of the consumption tax treatment of fringe benefits under H.R. 1165, 99th Cong., 1st Sess., see Simon, *supra* note 4, at 1204-06.

8. This article will not, however, address taxation of items such as paid vacations and flexible work schedules, considered within the broadest definition of fringe benefit. The Bureau of Labor Statistics includes such items in its compilation of employee benefits. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS IN INDUSTRY, 1980, Bull. 2107, 1-2 (1981). The reason for not including them is that compensation paid for periods not worked is already taxed as income. Although amounts paid for leisure could be taxed at higher rates than

Historically, certain fringe benefits coming within the broad scope of the definition given above have been excluded from the tax base because they are characterized as "conditions of employment" rather than taxable items of compensation. It has been long accepted that items coming within the "working condition" definition are nontaxable despite the difficulty in defining the term precisely.[9] Yet the fact that the employer furnishes working conditions principally to provide a better working environment for the employees (an essentially noncompensatory reason) certainly does not eliminate the compensatory value to the employee who would continue to exist quite well without the carpet or pictures. Nevertheless, suggesting that ordinary office furnishings ought to be included in income is similar to suggesting that the psychic pleasure derived from enjoying a job should be included in a person's taxable income. While taxing such intangible benefits has been suggested as a theoretical possibility by well-respected commentators such as Henry Simons,[10] broadening the definition of income to include intangible psychic income in the base would make no sense because of the practical difficulties of measurement. The same can be said of many fringe benefits that are essentially working conditions. On the other hand, the wide-ranging exclusions of compensatory fringe benefits, as opposed to

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other compensation, development of such a scheme would lead to unnecessary and undesirable complications.

9. The use of the imprecise term "working condition" or "condition of employment" is fraught with the same difficulties as is the use of the term "fringe benefit." For discussions of the two terms, see, e.g., H. MACAULAY, FRINGE BENEFITS AND THEIR FEDERAL TAX TREATMENT 4-8 (1959); H. SIMONS, PERSONAL INCOME TAXATION 52-53 (1938); J. SNEED, CONFIGURATIONS OF GROSS INCOME 101-04 (1967). *See also* Finnerman, *Fringe Benefit or "Condition of Employment": Uniformity, Certainty and Compliance*, 78 NW. U.L. REV. 193 (1983).

While counsel to the CIO, former Justice Arthur Goldberg urged a broad interpretation of the term "working conditions" for tax purposes. *See* A. Goldberg, "Compensation Other Than Cash," Paper Presented before the Section of Taxation at the American Bar Association (Sept. 18, 1951), *cited in* Guttentag, Leonard & Rodewald, *Federal Income Taxation of Fringe Benefits: A Specific Proposal*, 6 NAT'L TAX J. 250, 252-53 (1953).

In a curious confusion of the two concepts, new § 132(a)(3) refers to one category of excludable benefits as the "working condition fringe." *See* I.R.C. § 132(a)(3) (West 1985). A working condition fringe is defined in § 132(d) as "any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167." *Id.*

The same confusion of terms can be found in the Macaulay book, where he notes that "conditions of work have also become important in compensating employees." H. MACAULAY, *supra.*

See also Prop. Reg. § 1.61-18 (draft), [1983] II FED. TAXES (P-H) ¶ 70,181. The proposed regulation defines a working condition as "any property, service or facility provided with the specific intent either to enable or facilitate the performance of employment services." *Id.* In addition, a working condition must generally be provided at the recipient's place of employment and during normal working hours. *Id.* As of this writing, the draft of the proposed regulation has not been withdrawn.

10. *See* H. SIMONS, *supra* note 9, at 53.

noncompensatory working conditions, from income create well known inequities our society must address.[11] Thus, limiting the definition of working conditions is crucial.

One of the principal reasons for the exclusion for working conditions is that they are difficult to value. Difficulty of valuation is a significant factor with respect to all other fringe benefits and an important rationale for excluding many of them. Valuation difficulties are not usually the major determinant of taxability or nontaxability. In the area of compensation in-kind, when one goes beyond necessary working conditions into the realm of private secretaries and free parking privileges, one might find that the valuation difficulties, although great, may be insufficient to outweigh the inclusion of the items in the taxable base.

Nevertheless, as the tax system has evolved from its simple beginnings in 1913 to the complexities of today, valuation difficulties have frequently been raised in efforts to exclude more fringe benefits from taxation. The result has been a blending of fringe benefits and nontaxable working conditions and a blurring of the distinction between them. That trend should not be allowed to continue. We need to create a system of taxation that does not depend on individual perceptions of worth, but instead succeeds in taxing those benefits that are compensatory, relatively easy to value and includable in the tax base from a policy standpoint. This article will advance a proposal designed to establish such a system of taxing fringe benefits, and it will explore the benefits of the system proposed as well as problems created by it.

From a historical perspective, it is clear that Congress has been reluctant to deal with the question of fringe benefits in a systematic manner that would establish such a general policy. That trend is continuing and accelerating, as the most recent foray into the problem of fringe benefits clearly demonstrates. Part II of this article, which discusses the manner in which the various nontaxable fringes have come into being, addresses this problem.

When one analyzes the history, it becomes quite clear that a mechanism for taxing fringe benefits would be a suitable reform mea-

11. Mathematical demonstrations of inequity may be found in Popkin, *The Taxation of Employee Fringe Benefits*, 22 B.C.L. REV. 439, 450 (1981) (demonstration of vertical inequity); Richmond, *Tax-Free Fringe Benefits and Social Security: Is it Time to Change the Rules?*, 6 NOVA L.J. 83, 89-91 (1981) (demonstration of horizontal inequity). *See also* Simon, *supra* note 4, at 1207-12. *See generally* Nolan, *Taxation of Fringe Benefits*, 30 NAT'L TAX J. 359 (1977) (analysis from the standpoint of simplification); Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141, 1142-48 (1976) (presenting as "Framework for Analysis" the various aspects of inequity and inefficiency). A more complex discussion of these matters can be found in Part IV.

sure. The proposal for taxing fringe benefits found in Part III of this article is just such a reform measure. Its technical aspects and practical impact are discussed in Part III. Finally, focusing on this proposal, Part IV demonstrates why any proposal, for tax reform must address the problem created by nontaxation of fringe benefits. The proposed vehicle for taxing fringe benefits is geared to the current system of income taxation, but could also serve as a model for other systems of taxation the United States may adopt in the future.[12]

II. The Existing Pattern — Current Exclusions from Income

To understand the importance of competely overhauling the way in which the current system taxes fringe benefits requires an understanding of what the system is and how it came about. Essentially three different types of fringe benefits are excluded by the current tax structure: long-time exclusions codified in the 1954 Code as originally enacted; exclusions provided by amendments to the Code, including those made in 1984; and exclusions by administrative regulation, ruling or "time-honored tradition" which have never been codified. Due to congressional action in 1984, this final group has shrunk. Clearly, however, some fringes still fall into the final category under current law.

Except for a few exclusions added to the Code in the late 1970's,

12. A change from the current progressive tax system to a flat-rate system, without some attempt to require the inclusion of a number of fringes in the income tax base, would increase the pressure on the labor market and tend to shift people into jobs providing the best untaxed fringes. As a result, more nontaxable benefits might be provided in those economic sectors which have not provided a significant amount of fringes. The transition, however, might prove dislocative for many people. The current trend in compensation is toward more fringes; as a result, allocative inefficiency may be expected to increase.

One of the recent "flat tax" bills introduced in Congress, The "Fair Tax Act," S. 409, 99th Cong., 1st Sess., 131 Cong. Rec. § 1172-93 (daily ed. Feb. 6, 1985), recognized the problem of fringe benefits in the system. The bill proposed to eliminate cafeteria plans, the most flexible of the current exclusions. *See infra* notes 174-83 and accompanying text. In addition, the bill would have repealed the exclusion for dependent care assistance plans and qualified transportation plans. Also, employer purchases of group term life insurance for employees would be taxable, as would employer purchases of health insurance or funding of health plans, except in very limited circumstances. The bill would include all unemployment compensation in the tax base. Although far-reaching changes, they do not repeal all exclusions currently in the law. It therefore seems appropriate to suggest additional analysis of these matters by the bill's supporters.

See also Hall & Rabushka, *Low Tax, Simple Tax, Flat Tax*, 17 U.C.D. L. Rev. 1009 (1984), where the authors noted the explosion of fringes is strictly an artifact of our tax system and is an economically inefficient way to pay people. Were the tax system neutral, taxing fringes at the same rate as cash wages, people would prefer to receive their income in cash and make their own decisions about health and life insurance, country club dues, exercise facilities, and the like. Furthermore, the failure to tax fringes ensures that taxes on other types of income are artificially high. Bringing all types of income under the same tax system is essential for low rates. For a more detailed analysis of the proper treatment of fringe benefits under a modified flat rate income tax system, see generally Simon, *supra* note 4.

the responsibility for the mishmash of exclusions must be shared by the Congress and Treasury Department. In the earliest stages of tax law administration, the Treasury took a relatively inflexible position that many non-cash benefits constituted income. This position gradually changed to the point that almost all of the specific exclusions contained in the 1954 Code had their origins in administrative determinations that the item in question was not properly includable in the tax base. Although some exclusions grew more directly out of provisions of previous revenue acts, many of those had their origins in administrative policy. It is, therefore, fair to say that the Treasury Department as a whole and the Internal Revenue Service in particular have played a major role in developing a relatively lenient fringe benefit policy. This policy has, of course, led to an enormous increase in fringe benefit compensation for the nation as a whole.[13]

Despite supervision by Treasury Department administrators, the development of separate exclusion provisions was never well coordinated with existing exclusions to ensure an overall coherent scheme. Particularly distressing is the lack of systematic analysis by the Treasury in its published decisions as to the taxability of the various benefits. The Treasury's analytical inconsistency gave Congress little guidance when it considered new Code provisions. The Treasury, in turn, was forced to reason by analogy and provide broader exclusions. This made it difficult to forcefully articulate any basis for opposing continued erosion of the tax base when these items came up in Congress. More recently, however, the Treasury decided to take policy-based positions that are opposed to the continual broadening and extending of legislative exclusions.[14]

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13. Between 1947 and 1957, companies reported to the United States Chamber of Commerce that all fringes, including paid leisure such as vacations, rose from 15% to 23.7% of payroll. H. MACAULAY, *supra* note 9, at 10. Congressman Barber Conable, the ranking Republican on the House Ways and Means Committee, suggested in a letter to constituents in December 1982, that fringe benefits at "top companies now amount to 35-40 per cent of the total cost of payroll." 18 TAX NOTES (TAX ANALYSTS) 15 (Jan. 3, 1983) (text of Conable letter). *See also Employees Get More Benefits*, N.Y. Times, Apr. 17, 1982, at 30, col. 1.

14. The Treasury decided in 1975 to tax certain fringe benefits about which it had previously made no clear policy choice. *See* Prop. Reg. § 1.61-16 (Discussion Draft), 40 Fed. Reg. 41,118 (1975), [1985] 2 FED. TAXES (P-H) ¶ 7371. Congress responded to the Treasury's desire to close some loopholes by enacting new ones, *see, e.g.*, I.R.C. § 132 (West 1985), and by preventing the Treasury from going ahead with its plans. In 1977 Congress imposed a moratorium on the issuance of fringe benefit regulations, which was later extended until December 31, 1983, by various provisions of other revenue laws. *See* Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 3, 92 Stat. 3097, 3097 (1978) (Oct. 1, 1977 through June 30, 1978); Act of Oct. 7, 1978, Pub. L. No. 95-427, § 1, 92 Stat. 996, 996 (May 1, 1978 through Dec. 31, 1979). A further extension was imposed by the Act of Dec. 29, 1979, Pub. L. No. 96-197, § 1, 93 Stat. 1275, 1275 (1979) (until May 31, 1981). The Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, § 801, 95 Stat. 172, 349 (1981), imposed a further moratorium which then expired at the end of 1983. Although the Treasury had complied with the moratorium by not issuing

A. *The 1954 Code as Originally Enacted*

1. Deferred Compensation Plans

By far the largest current exclusion is employer contributions to pension and other qualified deferred compensation plans for the benefit of employees and their beneficiaries. Coupled with the exclusion for income earned on invested pension funds, the tax expenditure for 1984 was estimated to be in excess of forty-seven and one-quarter billion dollars, and will rise to more than eighty-two and three-quarters billion by 1989.[15] The present exclusion provisions for pension, profit-sharing and other deferred compensation plans are extremely complex and provide complicated rules for plan qualification, vesting standards and taxation on distributions.[16] The current system is the product of many years of tinkering with exclusion statutes, the first of which appeared in 1921. The manner in which employer-provided retirement benefits are taxed to the employee has not, however, differed significantly from its original 1913 form.

The earliest ruling regarding pension plans, coming at a time when no specific section of the law required inclusion, provided that "pensions or retiring allowances paid by the United States or private persons" were deemed to constitute income.[17] This rule was announced without explicit statutory authority as a corollary to regulations treating deductions for expenses for employee compensation under the Revenue Act of 1913. The earliest reference to the income tax treatment of pensions is thus found in the rules for determining

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any final regulations while it existed, it did issue the second discussion draft in early January 1981. *See* Prop. Reg. § 1.61-18 (draft), [1981] II FED. TAXES (P-H) ¶ 70,181. After that, however, the Treasury preferred to allow Congress time to deal with the issues. *See* Daily Tax Rep. (BNA), June 17, 1981, at G-2. Later, after the 1981 Act extension of the moratorium, the Treasury announced that it and the Internal Revenue Service would not issue "any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985." *See* Ann. 84-5, 1984-4 I.R.B. 31. By that time, of course, there was a new statute.

More recently, the Treasury opposed the extension of the § 127 exclusion for educational assistance programs. *See* Daily Tax Rep. (BNA), Apr. 29, 1983, at J-8 (statement by William S. McKee, Acting Deputy Assistant Secretary for Treasury for Tax Policy, at Hearing on Apr. 29, 1983, of Senate Finance Comm. Subcomm. on Taxation & Debt Management). But it, of course, had no success. *See infra* note 200 and accompanying text.

The current Treasury took a cautious position regarding legislation now codified in §§ 132 & 117(d). *Administration's Fiscal Year 1984 Budget Proposals—II: Hearings Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. 28-32 (1983) (testimony of John Chapoton, Assistant Secretary of the Treasury for Tax Policy) [hereinafter cited as *Hearings*].

15. Joint Comm. on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1984-1989*, 25 TAX NOTES (TAX ANALYSTS) 721, 727 (Nov. 19, 1984).

16. I.R.C. §§ 401-25 (West 1985). For an analysis of the present law, see generally 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 60-62 (1981) and the articles cited therein.

17. Regulations 45, art. 32, 21 Treas. Dec. Int. Rev. 180 (1919).

the deductibility of the amounts paid as ordinary and necessary business expenses in Regulations 33, promulgated under the first revenue acts.[18] Article 136 of Regulations 33 (Revised) denied a deduction for amounts contributed to a trust established for the purpose of paying employee pensions, allowing instead a deduction for "the amount actually paid to the employee."[19] The placement of Article 136 in those regulations clearly suggests that the issue was principally one of distinguishing such payments from "donations," made to employees, that lacked an element of compensation and, therefore, were nondeductible as ordinary and necessary business expenses.[20] Apparently, the employer deduction was tied to an inclusion by an employee or other beneficiary. Therefore, gifts, excludable under both the previous and current statute,[21] could not give rise to a deduction whereas "compensation," clearly includable under section II(B) of the 1913 Revenue Act could.

Thus, from the beginning, the proper time for the employer to take a deduction has been when the employee has an inclusion in income, that is, when there is a payout from a plan or a trust. No deduction was available when the employer contributed to the pension fund. Presumably, under general cash accounting principles these employer contributions were excludable from the employees' income at the time they were made, but there was no need to address this issue since the timing of the deduction was deferred to match that of the inclusion.

The remaining issue of the taxability of the earnings on the funds set aside in trust or otherwise for the future payment of pensions to employees, led to the first congressional action regarding pensions in 1921. In 1920 the Internal Revenue Service ruled that an employer

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18. The Treasury first promulgated Regulations 33 under the Revenue Act of 1913, ch. 16, 38 Stat. 114 (1914). Apparently, the official promulgation of the Regulations was contained in T.D. 1944, which should be found between T.D. 1943 and T.D. 1945 in the official Treasury Department publication of Treasury Decisions. Volume 16 of the series of Treasury Decisions, however, allegedly published in 1915, contains a blank space where T.D. 1944 should be found on page 26, despite a reference to T.D. 1944 in the index at 314. 16 Treas. Dec. Int. Rev. 23-27 (1918). The entire "Regulations No. 33, Revised," promulgated on January 2, 1918, is found at the back of volume 16.

19. Regulations 33 (Revised), art. 136, 16 Treas. Dec. Int. Rev. 73 (1918). The deduction was for amounts paid as pensions to retired employees, families, and dependents. This is distinct from amounts paid to an employee's widow or heirs in continuation of the employee's salary "in recognition of the services rendered by the individual," amounts which were not determined to be deductible because they were not "ordinary and necessary." Regulations 33 (Revised), art. 137, 16 Treas. Dec. Int. Rev. 73 (1918). The next set of regulations promulgated pursuant to the Revenue Act of 1918, eliminated this difference in treatment. *See* Regulations 45, art. 108, 21 Treas. Dec. Int. Rev. 204 (1919).

20. Regulations 33 (Revised), art. 135, 16 Treas. Dec. Int. Rev. 73 (1918).

21. *See* Revenue Act of 1916, ch. 463, § 4, 39 Stat. 756.

would be taxed on earnings of a revocable profit-sharing trust because those amounts were under the employer's control and could be used for business purposes.[22] In 1921 Congress made its first foray into the treatment of pension and other employee benefit plans specifically to overrule this IRS ruling, and in doing so, it laid the foundation for the development of the current system.

The 1921 provision was a part of the section concerning the taxation of trusts and their beneficiaries and it specifically excluded the employer from taxation on the earnings of the trust.[23] Although the new provision did not specifically exclude from employee's income contributions to exempt stock-bonus or profit-sharing trusts when made, that result was mandated by the manner in which beneficiaries were taxed: "[T]he amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds amounts paid in by him."[24] This essentially confirmed the Treasury's treatment of contributions, but it did not deal with the question of deducting them. The 1926 Act added pension trusts to the taxation system, but remained silent on plan contributions.

Finally, in 1928 a new section explicitly provided for an employer deduction when a plan contribution was made to a specific type of trust.[25] Thus, from 1928 on, the statute recognized the forerunner of today's "qualified plan"[26] and permitted a deduction for certain contributions coupled with a deferred inclusion for the employee and exclusion of earnings on the invested funds from the employer's income. Apart from a 1938 revision which restricted employer access to the funds if the trust was to qualify for an exemption,[27] the numerous amendments made during the next few years were designed only to shield all appreciation in the value of the trust assets from being characterized as income to a distributee.[28]

In 1942, however, a major change was made in what was then section 165 of the 1939 Code. The general scheme of exclusion for employer contributions to qualified plans, coupled with deferred inclusion of the benefits, remained the same.[29] Congress, however, enacted

22. *See* Solicitor's Memorandum 1329, 2 C.B. 69 (1920).

23. Revenue Act of 1921, ch. 136, § 219(f), 42 Stat. 227.

24. *Id.*

25. *See* Revenue Act of 1928, ch. 852, 45 Stat. 791 (new § 23 explicitly provided a deduction for contributions to pension trusts).

26. I.R.C. § 401(a) (West 1985).

27. *See* Revenue Act of 1938, ch. 289, 54 Stat. 447.

28. *See* Revenue Act of 1936, ch. 690, 49 Stat. 1648; Revenue Act of 1932, ch. 209, 47 Stat. 169.

29. *See* H.R. REP. No. 920, 81st Cong., 1st Sess. 4, *reprinted in* 1942-2 C.B. 285, 287.

section 165(c), which provided that a beneficiary of a *nonexempt* trust would be taxed on contributions made by the employer in the year in which the beneficial interest in them became nonforfeitable.[30] Section 165(c) represented the first retreat from the general notion of excluding employer contributions and including only benefits paid out. Such treatment of nonqualified plans is clearly appropriate today.[31]

Between 1942 and the enactment of the 1954 Code, little legislative activity occurred in the pension area. With the 1954 Code, Congress enacted a comprehensive scheme for taxing pension plans and their corresponding contributions and distributions.[32] Since that time, in addition to frequent tinkering,[33] Congress has passed two substantial amendatory acts shaping the current scheme of taxation in the pension area.

The first of these acts, the Employee Retirement Income Security Act of 1974 (ERISA),[34] made sweeping changes in the law. No change was made in the general rule of nontaxability of contributions to plans, but the requirements for plan qualification were tightened considerably.[35] More recently, in 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA)[36] made additional fundamental changes in the manner in which self-employed and employer-funded plans are taxed. The system progressed from one in which there was substantial inequality between the two to one where the amounts that may be contributed without current inclusion in the income of the employee or self-employed person are essentially the same.[37]

This discussion of the development of the pension plan legislation shows that the general tax treatment of pensions has not varied much since the 1920's. Thus, the major benefit that employees derive

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30. *Id.* The 1942 Act provided that the amount distributed was to be taxed to the distributee "as if it were an annuity," thus taking into account the "investment in the contract." *Id.*

31. I.R.C. § 404(a)(5) (West 1985).

32. *See* Revenue Act of 1954, ch. 736, §§ 401-04 & 421, 68 Stat. 1, 134-47.

33. For an analysis of the legislative changes made to the 1954 Code in the area of pensions, see generally STAFF OF SUBCOMM. ON LABOR OF SENATE COMM. ON LABOR & PUBLIC WELFARE, 94TH CONG., 2D SESS., LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 (Comm. Print 1976) (ERISA); Tax Mgmt. Portfolio (BNA) No. 314 (1976) (post-ERISA); Goodman, *Legislative Development of the Federal Tax Treatment of Pension and Profit-Sharing Plans*, 49 TAXES 226 (1971) (pre-ERISA).

34. Pub. L. No. 93-406, 88 Stat. 829.

35. The Pension Equity Tax Act, H.R. 6410, proposed in the first session of the 97th Congress, involved standards similar to the current § 410 anti-discrimination standards for qualification of all employee benefit plans. *See* [1982] 9 FED. TAXES (P-H) ¶ 60,247. The only part of this anti-discrimination proposal that survived in The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was an amendment to § 79. *See infra* note 160.

36. Pub. L. No. 97-248, 96 Stat. 323.

37. *Id.*

from the exclusion of employers' contributions has consistently been the benefit of deferral. In addition, there is a possible reduction in the amount of tax paid as a result of the lower rates that apply to smaller amounts of income (this is particularly true if the taxpayer takes advantage of ten-year averaging). Nevertheless, the issue with respect to the taxability of pension plan contributions is not "whether," but "when."[38]

Pension plans are an extremely important factor in the current labor market and in the economy as a whole. The assets they own are tremendous and contribute to the power of the plans' trustees. A scheme, such as the one proposed in this article, that would tax currently employer contributions to the plans might be strongly resisted. However, the deduction mechanism that is designed to continue the current system with a little less complexity would presumably overcome some of that resistance.[39] Thus, although current inclusion of the contributions might be required, providing a deduction for a specific amount of contributions to certain types of plans would alleviate much of the burden produced by the inclusion.

2. Employee Stock Option Plans

Unlike pension and other retirement benefit plans, the deferred compensation arrangement known as a stock option plan had a rather involved history prior to the enactment of the 1954 Code. Nevertheless, by 1954 it was reasonably well settled that two different types of stock option plans had emerged. Of the two, only a "statutory" plan gives deferral. Under a "nonstatutory" plan, the employee is taxed on the fair market value of the spread at the time the option is granted. If the option does not have a fair market value, the time of exercise is the time of tax. Under a statutory plan, of which there are currently two types (incentive stock options, defined in section 422A, and employee stock purchase plans, defined in section 423), the employee is not taxed until the stock is sold, at which time any compensatory element is taxed as capital gain.[40] Thus, unlike pensions on

38. Deferral should not be regarded as an insubstantial tax benefit. Creating a deduction for an amount of money put into a retirement account, which is what an exclusion essentially does, is at least as valuable as creating an exemption for the return from the savings made through the investment in the retirement plan. The length of time of deferral is also a significant feature. *Cf.* Halperin, *The Time Value of Money — 1984*, 23 TAX NOTES (TAX ANALYSTS) 744, 751-52 (May 14, 1984).

39. *See infra* text accompanying notes 350-53.

40. The employee stock purchase plan (ESOP), defined in § 423, also provides deferral under the current statute. Congress added that provision in 1964, and such plans generally cover a broader group of employees than other option plans. *See* Revenue Act of 1964, Pub. L. No. 88-272, § 423, 78 Stat. 19, 67 (general benefits, deferral plus conversion, are the same).

which the tax is merely deferred, with stock options the deferral is coupled with conversion of ordinary income to capital gain.

Stock options have long been used as employee benefits, but for many years their tax status was in doubt. The conceptual difficulty that existed for some time with respect to taxing the compensatory element in a bargain purchase of the employer's stock was related to the existence of the two elements of such purchases — the fact that the transaction itself was a purchase[41] and the fact that it was made for less than fair market value in an employment setting. Because of these two factors, the Board of Tax Appeals in *Geeseman v. Commissioner* developed what became known as the "propriety interest doctrine." This doctrine excluded from income any value in the option if the purpose of the option was to encourage equity participation by the employee in the business.[42]

The Commissioner accepted the Board's theory in *Geeseman*,[43] and amended the applicable regulations to distinguish between compensatory and proprietary stock options; the former were held to be taxable while the latter were not.[44] The disparate treatment between the employee paid in cash who was permitted to buy stock and the employee given a "proprietary" stock option was obvious and employees began to demand such options as a part of their compensation packages. In addition, there was a disparity in the treatment of fringe benefits resulting from bargain purchases of stock and bargain purchases of other items not covered in the amendments to the regulations. Although it is not altogether clear, it seems that bargain purchases of manufactured goods, for example, were considered to be taxable.[45]

Despite the acquiescence in *Geeseman*, the Commissioner continued to litigate questions about the taxability of stock options, and finally won a victory in *Commissioner v. Smith*, decided in 1945.[46] In

41. *See* Manomet Cranberry Co. v. Commissioner, 1 B.T.A. 706 (1925) (ordinary arms length purchase would not result in receipt of income even though the acquired property was worth more than the price paid). *See also* Hunley v. Commissioner, 25 T.C.M. 355 (1966). In 1923, the Treasury attempted for the first time to tax the bargain element both in a sale by a corporation to a shareholder and in a sale by an employer to an employee. The latter sale was taxed as compensation and the former was taxed as a dividend. *See* T.D. 3435, II-1 C.B. 50 (1923). The Supreme Court in Palmer v. Commissioner, 302 U.S. 63, 70 (1937), held the bargain element of a shareholder purchase of corporate assets had to constitute a distribution of earnings to be a dividend. This holding tends to support the analysis used in employee stock purchases that the bargain element must be intended as compensatory.

42. 38 B.T.A. 258 (1938).

43. *Acq.*, 1939-1 C.B. 13.

44. *See* Treas. Reg. 101, art. 22(a)-1; T.D. 4879, 1939-1 C.B. 159, *amending* the same article of Treas. Reg. 86 (1934) and 94 (1936).

45. *See* Regulations 33 (Revised), art. 4, § 21, 1 Treas. Dec. Int. Rev. 22 (1918).

46. 324 U.S. 177, *aff'd on reh'g*, 324 U.S. 695 (1945). This holding accorded with Old

Smith, the Supreme Court held the statute was "broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[47] This included the value of the "spread" in a stock option, the difference between the fair market value of the property and the amount paid for it. The Tax Court in *Smith* had held that the option did not have a market value when it was issued. Therefore, the Supreme Court held that the time for taxing the compensatory element in the option was at the time of exercise.[48] But the Court's opinion left open the possibility that if the option could be valued when granted, it might be taxed then, with no further consequences upon exercise. Accordingly, the Treasury issued new regulations in 1946 to tax all stock options in that manner.[49]

In 1950 Congress sought to reverse the trend toward taxing stock options by providing for certain executive compensation arrangements that would permit deferral for employees.[50] To achieve the desired deferral, the employer was required to transfer a stock option and the stock to the employee according to fairly definite rules permitting "restricted" stock option plans. In 1964 Congress terminated the use of restricted stock option plans. Rules under which an option could be received and exercised by an employee without tax consequences were set out in a totally new section which created "qualified" stock option plans and which was substantially stricter and more limited than its predecessor.[51]

In the meantime, the Supreme Court decided *Commissioner v. Lo*

Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) (holding payment of an employee's tax liability by an employer to constitute income).

47. 324 U.S. at 181.

48. *Id.* at 695. Under the *Smith* facts, the initial "exercise" did not effectively pass title in the stock to the taxpayer, and the Tax Court held the time for taxing the income was in the year of the delivery of the stock. The Treasury had originally published a ruling in 1938 that adopted as the time for taxation the time of exercise and as the amount subject to tax the "spread." *See* I.T. 3204, 1938-2 C.B. 126.

49. T.D. 5507, 1946-1 C.B. 18; I.T. 3795, 1946-1 C.B. 15. The Tax Court nonetheless felt compelled to continue to distinguish between proprietary and compensatory options. *See, e.g.*, Lo Bue v. Commissioner, 22 T.C. 440 (1954); Rosenberg v. Commissioner, 20 T.C. 5 (1953); Nicholson v. Commissioner, 13 T.C. 690 (1949).

50. Revenue Act of 1950, ch. 994, § 218, 64 Stat. 906. In its report on the amendments creating "restricted" stock option plans, the Senate Finance Committee noted its disagreement with the Treasury's application of the *Smith* rule on all stock options, whether or not they were "proprietary." *See* S. REP. No. 2375, 81st Cong., 2d Sess. 59, *reprinted in* 1950 U.S. CODE CONG. & AD. NEWS 3053, 3155.

51. Revenue Act of 1964, Pub. L. No. 88-272, § 221(a), 78 Stat. 19, 63-64. Old § 421 was renumbered § 424 in the process. For an analysis of the similarities and differences between "restricted" and "qualified" stock option plans, see Baker, *Employee Stock Option Plans Under the Revenue Act of 1964*, 20 TAX L. REV. 77 (1964).

Bue.[52] That case reached essentially the same result as *Smith*, but made it clear that options without a readily ascertainable fair market value (even if they had acknowledged value) were taxable at the time of exercise in the amount of the spread between the option price and the fair market value of the stock on that date.[53] Thus, the *Lo Bue* case created substantial certainty as to the taxable event and its proper timing where stock options are used as compensation for employees by opting, in almost all instances, for measurement of and inclusion in income when it is easiest to measure the amount to be included. The result in *Lo Bue* made the treatment of stock options not covered by the 1950 legislation similar to the treatment of other taxable employee bargain purchases, deferring the timing of the income until the time of purchase. The right to purchase conferred earlier was thought to be too amorphous and thus too difficult of valuation to be the occasion for taxation.

The difficulty with a rule that defers taxation until the purchase of stock is that in an inflationary economy or where stock prices are increasing for other reasons, it produces additional compensation income attributable only to appreciation in value of the property subject to the option. Offsetting the pain of including an additional amount in income in a deferred purchase situation pursuant to an option is the balm of deferral. Particularly in the case of stock, an employee's worth may be much enhanced, even though his spendable income is not, as a result of ownership of an option to acquire stock whose exercise is somehow restricted.

A similar enhancement of wealth is accomplished when an item of property is transferred outright but subject to restrictions on its complete ownership or use. If the restrictions on the option were sufficient to cause the option to not have a readily ascertainable fair market value, the 1946 regulations required the inclusion of income not at the time of grant, but at the time of exercise, and deferral was available. Those regulations did not, however, address the situation where property is transferred outright but subject to restrictions that make the circumstances not materially different from the transfer of an option. Nor did the regulations solve the potential problem that arises when an immediately exercisable option is granted but the property obtainable upon the exercise of the option is subject to restrictions.

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52. 351 U.S. 243 (1956). This case also ended the proprietary-compensatory dispute: "In our view there is no statutory basis for the test established by the court below. When assets are transferred by an employer to an employee to secure better services they are plainly compensation." *Id.* at 247.

53. *Id.* at 249.

These gaps in the regulations were made more obvious by *Kuchman v. Commissioner*,[54] a 1952 Tax Court decision that permitted stock subject to a relatively meaningless resale requirement to be excluded from income in the year of issue.[55] In *Lehman v. Commissioner*,[56] decided a year earlier, the Tax Court had held that the time at which any restriction lapsed was not the proper time for taxing the compensation.[57] The *Kuchman* decision, taken together with *Lehman*, created a serious problem for the Treasury in its attempt to time the taxable event in accordance with *Lo Bue*. These decisions essentially made the receipt of a valuable share of restricted stock, clearly transferred for compensatory purposes, never taxable to the transferee as income.

The Treasury sought to remedy the defects in the earlier regulations with new regulations, proposed in 1956 and finalized in 1959. These new regulations set out comprehensive rules governing the treatment of transfers of restricted property and options not covered by section 421, the "qualified" stock option provision.[58] But the 1959 regulations themselves left open certain loopholes.[59] Not surprisingly, restricted stock purchase plans tailor-made to fit within the regulations' parameters became very popular because they permitted circumvention of the rules for qualified stock option plans and also placed a clear limit on the amount of income from the receipt of the option that would be subject to tax. In 1968, the Treasury proposed another set of regulations that would have eliminated the benefits available through the use of such arrangements.[60] However, the regulations were never finalized because Congress enacted section 83 in 1969 to provide clear rules for taxing transfers of restricted property.[61]

The benefits available under "qualified" employee stock option plans were also curtailed at the time section 83 was enacted.[62] In 1976 an even more reform-minded Congress decided to eliminate such plans altogether as of May 20, 1976.[63] In its place, Congress ap-

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54. 18 T.C. 154 (1952), *acq.*, 1952-2 C.B. 2.

55. *Id.*

56. 17 T.C. 652 (1951), *acq. on this issue withdrawn and nonacq. substituted*, 1962-1 C.B. 7. The Tax Court belatedly overruled *Lehman* in Lighthill v. Commissioner, 66 T.C. 940 (1976).

57. *Lehman*, 17 T.C. at 652.

58. *See* Treas. Reg. § 1.42-6(d) (1959) (stock options); *id.* § 1.61-2(d)(5) (restricted property), *promulgated by* T.D. 6416, 1959-2 C.B. 126.

59. The 1959 regulations limited the taxable amount to the spread at the time of the grant in deference to the *Kuchman* decision. *See* T.D. 6416, 1959-2 C.B. 126.

60. 38 Fed. Reg. 15870 (1968).

61. *See generally infra* Part IV.

62. *See* S. Rep. No. 552, 91st Cong., 1st Sess. 120, *reprinted in* 1969-3 C.B. 423, 500.

63. *See* I.R.C. § 422(b) (1976) (defining a qualified stock option as one which must be

parently adopted the rule of section 83 as the operative provision governing the timing and amount of income includable by the recipient.[64] No amendment to the statute was made, nor does it seem that one was necessary given the broad scope of section 83.[65] Nonetheless, the entire matter was rendered moot in a complete policy reversal by the 97th Congress which recreated, with numerous changes, the old "qualified plan" as the "incentive stock option" (shades of *Geeseman*) under section 422A. The rules of the new provision were generally made applicable to options granted after January 1, 1976, and exercised or outstanding after December 21, 1980,[66] effectively ousting section 83 from the stock option field altogether.

3. Employee Death Benefits

Turning from pension plans and other deferred compensation plans to other exclusion provisions in the original 1954 Code, one finds that they all involve complete forgiveness of tax as opposed to deferral or deferral plus conversion. The first of these, the employee death benefit exclusion under section 101(b), does not amount to much in actual dollars per employee ($5,000).[67] Nor is it a large enough aggregate amount on a national basis to merit mention in the Joint Committee's tax expenditure estimates.[68] The history of the provision is interesting, however, in that it shows an early lack of sophistication of the Treasury regarding compensation issues.

In its first published ruling on the question of how death benefits should be treated both for the employer and for the recipient of the payment, the government was consistent in its conclusion that the payment should be given gift status for both parties.[69] The position as to the employer was reiterated in the first set of regulations published by the Treasury.[70] But as early as 1919 there was a reversal

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granted on or before May 20, 1976).

64. *See* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 94th Cong., 2d Sess. 152 (1976), *reprinted in* 1976-3 (vol. 2) C.B. 165. The regulations under I.R.C. § 83 were appropriately amended. *See* Treas. Reg. § 1.83-7 (1978).

65. *Cf.* Pomeroy, *The Metamorphosis of the Nonqualified Stock Option Under the Tax Reform Act of 1976 — The Strange Case of the Disappearing Loophole*, 54 TAXES 761 (1976) (criticizing Congress for not explicitly changing the law).

66. *See* I.R.C. § 422A(c) (1982), *added by* the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 251, 95 Stat. 172, 256 (1981).

67. *See* Joint Comm. on Taxation, *Estimate of Federal Tax Expenditures for Fiscal Years 1984-1989*, 29 TAX NOTES (TAX ANALYSTS) 721, 727 (Nov. 19, 1985).

68. *Id.*

69. *See* T.D. 2090, 16 Treas. Dec. Int. Rev. 259, 267-68 (1914).

70. *See* Regulations 33 (Revised), art. 137, 20 Treas. Dec. Int. Rev. 195 (1918) (no deduction as the widow and heirs had rendered no services).

and, without explanation, an employer deduction was allowed.[71] Shortly thereafter, the government issued a ruling giving a gift exclusion to the recipient.[72]

Finally, in 1939, a comprehensive ruling was issued restating and explaining the gift/deduction treatment.[73] Because the surviving spouse or other beneficiary of the employee had rendered no services to the employer, the Treasury ruled that a payment to such person was entirely gratuitous. It was necessary for exclusion, however, that there was no contractual commitment to make the payment, because such a commitment would tend to negate a gift motive. Thus, the resolution authorizing the payment could state that the payment was made for past services by the decedent employee so as to preserve the business expense deduction. In addition, a gift exclusion by the surviving spouse was permitted. Contested cases were, of course, numerous.[74]

In 1950, however, the Internal Revenue Service decided to make the stakes the same for both parties by issuing a new ruling that required the payments made by reason of an employee's death to be income because they were made in consideration of services rendered by the employee even though no services had been rendered by the surviving spouse.[75] The IRS indicated that the mistake of the previous rulings had been to focus on the recipient rather than the payor with respect to the rendering of services. The IRS determined that the new approach was more reflective of the general economics of the situation than the gift theory. The Tax Court, in a series of cases decided after the change in the IRS position, disagreed.[76] The inclusion issue was settled by Congress in 1951[77] when it enacted the predecessor of section 101(b) and allowed a limited exclusion.

The legislative history of the new section indicates that the principal motivating force for the change was that in comparing the ex-

71. *See* Regulations 45, art. 108, 21 Treas. Dec. Int. Rev. 204 (1919) (deduction allowed).

72. *See* O.D. 1017, 5 C.B. 101 (1921).

73. *See* I.T. 3329, 1939-2 C.B. 153, holding the payment deductible as a business expense and reiterating the position regarding gift treatment to the widow taken in O.D. 1017, 5 C.B. 101 (1921).

74. *See, e.g.*, Brayton v. Welch, 39 F. Supp. 537 (D. Mass. 1941); Aprill v. Commissioner, 13 T.C. 707 (1949).

75. *See* I.T. 4027, 1950-2 C.B. 9, 10.

76. *See* Luntz v. Commissioner, 29 T.C. 647 (1958); Estate of Foote v. Commissioner, 28 T.C. 547 (1957); Estate of Hellstrom v. Commissioner, 24 T.C. 916 (1955); MacFarlane v. Commissioner, 19 T.C. 9 (1952). *See also* Rodner v. United States, 149 F. Supp. 233 (S.D.N.Y. 1957). For a discussion of these cases, see Crown, *Payments to Corporate Executives' Widows*, N.Y.U. 19TH INST. ON FED. TAX'N 815 (1961); Pelisek, *Tax Treatment of Payments to the Widows of Corporate Officers and Employees*, 44 MARQ. L. REV. 16 (1960).

77. Revenue Act of 1951, ch. 521, § 302, 65 Stat. 452, 453, *amending* I.R.C. § 22(b)(1) (1939).

clusion from tax for life insurance proceeds with the taxability of death benefits that were not funded by life insurance, that there was a "hardship" that needed correcting.[78] The correction was not a major one, however, as the exclusion was limited to $5,000 from the outset, as compared to the unlimited exclusion for the proceeds of life insurance under what is now section 101(a). The disparity between the amounts excludable under the two different subsections of section 101 has obviously increased since 1954 as a result of inflation, making the current $5,000 exclusion somewhat silly. Interestingly, this is one of only two exclusions for fringe benefits that the President's tax reform proposal plans to abolish.[79]

The 1951 legislation did not resolve the question of whether and under what circumstances a gift exclusion might be available in addition to, or instead of, the death benefit exclusion. Thus the litigation continued, and there were well-known attempts to whipsaw the government on the deduction/exclusion issues.[80] Congress eliminated one point of contention with the enactment of the 1954 Code when it deleted the requirement of the 1951 provision that the benefit be paid under a contractual agreement. Finally, in 1962, the enactment of the $25 limitation on the deductibility of business gifts resolved these matters in an unintended fashion.[81] Under section 274(b), an employer cannot deduct gifts in excess of $25 per employee per year if the gifts are excludable from income under section 102.[82]

4. Employee Health Benefits

One of the most common fringe benefits available to employees is

78. *See* S. REP. No. 781, 82 Cong., 1st Sess. 50, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 1969, 2020-21.

79. *See* PRESIDENT'S PROPOSAL, *supra* note 4, ¶ 3.02.

80. *See* Loewy Drug Co. v. United States, 356 F.2d 928 (4th Cir. 1966) (corporate payor denied deduction because of concession that payment was a gift and that no corporate benefit was involved); Poyner v. Commissioner, 301 F.2d 287 (4th Cir. 1962) (allegation that payor intended a gift is possible on the facts, Tax Court decision vacated and proceeding remanded). *Cf.* Bank of Palm Beach & Trust Co. v. United States, 476 F.2d 1343 (Ct. Cl. 1973) (payments to deceased employee's widow deductible under § 162 even though gift to widow); Fifth Avenue Coach Lines, Inc. v. Commissioner, 31 T.C. 1080 (1959) (deduction allowed even though gift treatment to the recipient possible), *rev'd on other grounds*, 281 F.2d 556 (2d Cir. 1960), *cert. denied*, 366 U.S. 964 (1961); Weyenberg Shoe Mfg. v. Commissioner, 23 T.C.M. (CCH) 1997 (1964) (gift treatment to widow does not itself prohibit § 162 deduction).

81. The Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, was clearly intended to reduce abuses in the area of business entertainment expenses and, to respond to President Kennedy's call for tax reform, included a limitation on the deductibility of business gifts. *See* H.R. REP. No. 1447, 87th Cong., 2d Sess. 19, *reprinted in* 1962-3 C.B. 405, 423. The provision of § 274 which makes gifts in the business context deductible only up to $25 per employee annually was part of the overall reform.

82. As it currently exists, I.R.C. § 274(b) (1982) is slightly more complicated than it was originally, but the thrust of the provision did not change.

accident and health benefits in some form or other.[83] The definition of employee health benefits covers a broad range, and includes on-site medical services for accidents occurring on the job, payment of premiums for health insurance, and paid sick leave. For on-premises infirmaries, the exclusion for the value of the care is similar to the general working condition exclusion. That is not true of health benefit plans which are not limited to job-related injuries.

There are two basic ways in which funded plans for health benefits are set up. First, benefits can be provided through insurance with the employer paying insurance premiums on behalf of the employee. Alternatively, the employer may act as a self-insurer by funding its own insurance plan. Under current law the treatment of the alternative methods of accomplishing the same result is the same so long as the amount received from the employer or through insurance is used for medical care. If, however, an amount paid through insurance or by an employer under a health plan is used for ordinary living expenses, there are severe restrictions on an exclusion with respect thereto. In addition to the exclusion of plan benefits, the actual funding of health plans by the employer also does not result in taxable income to the employee.

This funding exclusion has not always existed, however. Under the 1913 Revenue Act, the Treasury created an exclusion for health benefits which covered "amounts received, through accident or health insurance."[84] This treatment seemed to be merely an extension to nonwork-related illness and injury of the exclusion for on-the-job medical treatment, generally considered to be merely a working condition. In accordance with this rule, the premiums paid by an employer to purchase accident and health policies were held to be income under the regulations.[85] Although the exclusion provision was not enacted by Congress until 1918,[86] it seems that the statute merely codified the existing law and that the Treasury believed that the interpretation constituted the proper treatment of health benefits as early as 1913.

On the deduction side, Regulations 33 (Revised), held that actual payments "on account of injuries received by employees, or lump-sum amounts paid as compensation for injuries, are proper deduc-

83. *See* Bureau of Labor Statistics, U.S. Dep't of Labor, Employee Benefits in Industry 3 (1980) ("Almost all of the workers covered by the survey were provided health insurance.").

84. *See* Regulations 33 (Revised), art. 136, 20 Treas. Dec. Int. Rev. 195 (1918).

85. *See* Regulations 45, art. 33, 21 Treas. Dec. Int. Rev. 180 (1919) ("Premiums paid by an employer on life, accident or health policies in favor of his employees as additional compensation of such employees are income to the employees.").

86. Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066.

tions as 'ordinary and necessary expenses.' "[87] Inclusion of premiums or contributions to self-funded plans, coupled with exclusion for payments by the insurer or the fund to recompense for medical and other incidental expenses in the case of actual illness or injury continued without change until the early 1940's. In 1943 the IRS issued a General Counsel's Memorandum providing inclusion of payments made by employers to individual employees in the event of sickness on the theory that the employer plan did not constitute insurance.[88] In 1953, as a forerunner to the 1954 Code changes, Congress granted an exclusion for employer contributions to employer-funded group plans.[89]

Beginning in 1954, the original tax structure for health benefits was altered significantly. Congress codified the 1953 exclusion for employer funding of accident and health plans at the time premium payment or employer contributions were made in section 106. But amounts received as compensation for personal injuries and sickness as a result of these employer contributions are generally includable in the income of the recipient under section 105(a) unless they fall within section 105(b) as reimbursements of amounts "expended for medical care."[90] Furthermore, the exclusion applies to reimbursements of amounts paid on behalf of the spouse and dependents of the employee, thus further extending the value of the exclusion for many taxpayers and moving the exclusion far beyond its origins in the jobsite infirmary.[91]

Ignoring the 1954 Code sick pay provision,[92] which has since been repealed,[93] it is clear that the changes made in 1954 were far greater and more fundamental than necessary to remedy the problems Congress thought existed.[94] Under the present system, a person is enti-

87. *See* Regulations 33 (Revised), art. 136, 16 Treas. Dec. Int. Rev. 73 (1918). The same rule was found in Regulations 45, art. 108, 21 Treas. Dec. Int. Rev. 204 (1920), which was promulgated subsequent to the enactment of the statute.

88. *See* G.C.M. 23511, 1943 C.B. 86. for a general discussion of pre-1954 plans, see Note, *Taxation of Employee Accident and Health Plans Before and Under the 1954 Code*, 64 YALE L.J. 222, 223-27 (1954).

89. *See* Rev. Rul. 209, 1953-2 C.B. 104; Rev. Rul. 103, 1953-1 C.B. 20.

90. *See* I.R.C. § 105(b) (1982).

91. The employee spouse and dependent expenses provision was added in 1954.

92. The 1954 statute provided an exclusion for wage continuation plan payments ("sick pay") far broader than currently available under § 105(d). *See* Internal Revenue Code of 1954, ch. 736, § 105(d), 68A Stat. 3, 31.

93. *See* Social Security Amendments of 1983, Pub. L. No. 98-21, § 122(b) & (d), 97 Stat. 65, 87.

94. Confusion had come about because the IRS was taking the position that an employer-created and funded plan was not covered by the language "accident or health insurance." The Seventh Circuit disagreed with the strict IRS reading of the statute in Epmeier v. United States, 199 F.2d 508 (7th Cir. 1952), although it made clear that features of an insurance ar-

tled to exclude both the premium payments or fund contributions by the employer and the insurance or plan proceeds to the extent that they are "expended for medical care." Thus, such an individual is in a much better position than the person who must pay part or all of the cost of insurance out of after-tax income. As the exclusion of section 105(b) applies to amounts received by employees whose employers purchased the insurance for them, it provides a clear benefit. To the extent that the expenditure of the funds received from the insurer provides a deduction because they are used to pay for medical treatment, the inclusion of the portion attributable to the employer contribution and the taking of a section 213 deduction would produce a wash. But two considerable hurdles must be crossed before a section 213 deduction is ordinarily available. The first is the five percent floor for the deductibility of any medical expenses added by TEFRA.[95] The second is the zero bracket amount, which is substantial enough to eliminate the separate deductibility of many expenses not covered by insurance. Thus it is possible that the entire amount attributable to the employer contribution will not be equaled by a deductible expense. This may happen year after year with respect to normal medical expenses incurred. Whenever it happens, the combination of the provisions results in complete exclusion of the employer-paid amount rather than deferral, thereby undercutting the limitations on the medical expense deduction imposed under section 213.

It is possible that legislation will be enacted within the next few years that puts a "cap" on the amount of excludable benefits under sections 104 and 105,[96] although this legislation is not popular with

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rangement were required. The *Epmeier* court's position was later sustained by the Supreme Court, but only subsequent to the enactment of § 105. *See* Haynes v. United States, 353 U.S. 81 (1957).

95. Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 202, 96 Stat. 323, 421 (amending I.R.C. § 213(a)).

96. *See* S. 640, 98th Cong., 1st Sess. § 2 (1983), introduced in 1983 by Senator Dole at the request of the Reagan Administration, which would have imposed such a cap for tax years beginning in 1984. The proposed limits were $175 per month for family coverage and $70 per month for individuals. In testimony before the Senate Finance Committee on June 22, 1983, Assistant Secretary of the Treasury Chapoton spoke in favor of the proposal. *Hearings, supra* note 14, at 28-29. He also indicated that the Administration favored an even more significant cut in the benefit in order to fund health insurance for the unemployed. A reduction in the limits to $169 and $68 would raise an estimated $300-$400 million in additional revenue to be used for that purpose. *Id.*

The $175 family/$70 individual ceilings surfaced again in TREASURY I, as part of the general plan to reduce excludable fringe benefits. *See* 2 TREASURY I, *supra* note 4, at 23-27. A rationale for the exclusion ceilings was that most lower income taxpayers would be unaffected by them. In the months subsequent to the publication of the original proposal, that aspect of the proposal seems to have receded in favor of the need to raise revenue and to make doing so much easier. Thus, in PRESIDENT'S PROPOSAL, the proposal is that the first $10 per month ($120 large segments of the public. While a move in that direction is certainly laudatory, it is by no means radical. Indeed, such a move may be somewhat inefficient in that it adds another level of complexity to the taxation system. Such a cap would, however, tend to preserve the benefit of the exclusion for those who most need it while preventing employers from loading up tax-free fringes for executives.[97]

5. Rental Value of Parsonages and Rental Allowances to Ministers

The parsonage exclusion available under section 107 of the Code is rather limited. In 1921 Congress decided to provide such an exclusion[98] and thereby override the position that had previously been taken by the Treasury.[99] The apparent reason for the government's position was that the parsonage was not furnished as a working condition by the employer for its convenience.[100] Presumably Congress changed the law to favor the clergy and give aid to religion at a time when Establishment Clause vigilance was less important than it is today.[101]

The first exclusion provision was only for actual in-kind furnishing of housing, but Congress extended the exclusion to cash allowances in 1954 in order to eliminate a perceived unfairness.[102] The section 107 exclusion does not appear particularly broad as it is written. Moreover, decisions have been rendered restricting it to actual payments for housing[103] and to ordained ministers or their counterparts.[104] This exclusion is thus not of major significance, but it is

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per year) of individual coverage or the first $25 per month ($300 per year) of family coverage will be included in income. *See* PRESIDENT'S PROPOSAL, *supra* note 4, at 26-28.

At this writing, the House Ways and Means Committee is in the process of marking up a bill that may well be the next Tax Reform Act. The material prepared for the markup by the staff of the Joint Committee includes an option to tax employer-provided health insurance above a $120 individual/$300 family cap. *See* JOINT COMM. ON TAXATION, TAX REFORM PROPOSALS IN CONNECTION WITH COMMITTEE ON WAYS AND MEANS MARKUP, XI.E (Comm. Print 1985).

97. *See* TREASURY I, *supra* note 4, at 23.

98. *See* Revenue Act of 1921, ch. 136, § 213(b)(11), 42 Stat. 227, 239.

99. *See* O.D. 862, 4 C.B. 85 (1921).

100. *See infra* notes 117-20 and accompanying text.

101. One wonders, however, about the truth of the last phrase when considering tuition tax credit legislation recently pending in Congress. This legislation bore a closer resemblance to the New York state law struck down in Committee for Pub. Educ. v. Nyquist, 413 U.S. 756 (1973), than to the law upheld in Mueller v. Allen, 103 S. Ct. 3062 (1983).

102. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 16-17, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4040.

103. *See* Boyer v. Commissioner, 69 T.C. 521 (1977); Eden v. Commissioner, 41 T.C. 605 (1964) (undesignated salary payments).

104. *See* Kirk v. Commissioner, 425 F.2d 492 (D.C. Cir.) (no functions of a sacerdotal character performed), *cert. denied*, 400 U.S. 853 (1970); Toavs v. Commissioner, 67 T.C. 897 (1977) (ordained minister performing services for religious-affiliated nonprofit organization not entitled to exclusion because organization was not a church); Colbert v. Commissioner, 61 T.C.

clear that the same theoretical conclusions suggest that it should be repealed along with the other fringe benefit exclusions.

6. Meals and Lodging Furnished for the Convenience of the Employer

The exclusion currently available for the value of meals and lodging reflects the development of an exclusion under administrative rulings and court decisions that began many years prior to the enactment of section 119 in 1954. The newly enacted section was intended to be a codification of portions of prior doctrine as well as a legislative overruling of some prior cases, but the major reason for its enactment appears to have been an attempt to provide clarity and to resolve issues that were frequently litigated.[105] Nevertheless, litigation has continued, with the courts being called upon to resolve a number of issues presented by the language of section 119 itself. There is, however, a single major theme running through the administrative, judicial, and legislative development: the exclusion is available only if the meals and lodging are furnished "for the convenience of the employer" (and other tests are met). A brief look at section 119's lengthy and convoluted development follows.

In keeping with its original policy of including in income items vaguely resembling compensation, the Treasury ruled in 1914 that officers and employees of the United States were required to include in income the value of quarters, heat and light furnished to them or the cash allowance paid in lieu of those items, commutation.[106] This was the first determination on the subject of meals and lodging furnished in-kind to employees, and it is most interesting in two respects. First, the ruling contains a reference to the "employer's convenience" doctrine,[107] later to become the most important justification for exclusion, albeit in a somewhat limited fashion. Although the value of quarters or commutation thereof was held to be includable in income, where "a greater number of rooms than that allowed by law [is assigned], it is assumed that the excess number is assigned for the convenience of the Government, and the money equivalent only of the number of rooms allowed by law shall be returned as income."[108] Second, the ruling dealt with items other than lodging. For amounts re-

449 (1974) (nonreligious organization paid a Baptist minister an allowance, but services he performed did not constitute religious worship); Lawrence v. Commissioner, 50 T.C. 494 (1968) (ordained Baptist minister did not perform religious "ordinances" and was not a minister of the gospel).

105. *See infra* note 132 and accompanying text.

106. *See* T.D. 2079, 16 Treas. Dec. Int. Rev. 249 (1914).

107. *Id.*

108. *Id.*

ceived as reimbursements for expenditures made or as allowances paid beforehand,[109] the ruling only required inclusion of the amount in excess of the expenses incurred while on government business.[110]

The 1914 ruling was followed less than a month later by Treasury Decision 2090, a "synopsis" of rulings issued under the 1913 Revenue Act. Treasury Decision 2090 includes a general statement to the effect that "[w]here an individual is furnished living quarters in addition to salary, the rental value of such living quarters is regarded as compensation subject to the income tax."[111] This confirmed the earlier holding.

The Treasury continued to adhere to its position regarding includability of lodging furnished in addition to wages through 1918, when Regulations 33 (Revised) was published.[112] The principle was eroded only one year later, however, with the publication of two rulings, one regarding seamen[113] and the other regarding Red Cross workers.[114] These rulings signaled the growing acceptance of the convenience of the employer doctrine. The first ruling involved the in-kind provision of meals and lodging on board ship, while the latter concerned payment of a cash "maintenance" allowance in lieu of wages, held to be includable only to the extent it exceeded actual living expenses. In both instances, the unarticulated assumption was that the employees had to be present where they were, not because they desired it but rather because there was no other way that the duties could be performed. Thus, the Treasury allowed an exclusion in the limited circumstances where the lodging furnished by the employer was essentially a working condition. Also important is that the Red Cross workers ruling involved an amount paid in cash and not in-kind. The application of the employer's convenience exclusion to cash reimbursements for meals and lodging has plagued the courts for many years.

In 1920, the Treasury published an amendment to the regulations acknowledging that employer's convenience is essentially the equivalent of working condition.[115] The reference in the new provision was to living quarters "such as camps," the value of which was

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109. Examples include per diem and mileage allowances.

110. *See* T.D. 2079, 16 Treas. Dec. Int. Rev. 249, 250 (1914). *See infra* notes 249-53 (employer reimbursements of employee business).

111. *See* T.D. 2090, 16 Treas. Dec. Int. Rev. 259, 263 (1914).

112. *See* Regulations 33 (Revised), art. 4, 20 Treas. Dec. Int. Rev. 129 (1918).

113. *See* O.D. 265, 1 C.B. 71 (1919). Interestingly, the analogy was drawn to shipmasters and their cabins in Lord Hannen's opinion in Tennant v. Smith, 3 Tax Cas. 158, 172 (H.L. 1892), the major case in England that developed the "convenience of the employer" doctrine.

114. *See* O.D. 11, 1 C.B. 66 (1919).

115. *See* Treas. Dec. 2992, 2 C.B. 76 (1920) (modifying Regulations 45, art. 33).

not includable in the employee's income when furnished for the convenience of the employer. The provision distinguished this situation from one in which the employee was paid a salary as compensation and "*in addition thereto* [was furnished] living quarters."[116] In the latter circumstances, the Treasury determined that the value of the living quarters was includable in income.

In 1921, the government further elucidated the new position in a series of rulings which determined the application of the convenience of the employer theory to various situations. The rulings cited a number of different factors to be taken into account in applying the convenience of the employer test: the employee must accept the meals and lodging in order to properly perform the work required by the employer;[117] a requirement that the employee live on the premises must be imposed by the "location and nature of the work;"[118] and the employer must properly account for the value of the meals and lodging given to the employee free of charge.[119] On the other hand, where the employees could choose where to live and still adequately perform their duties, no exclusion was allowed.[120]

From these rulings it is clear that by the early 1920's the Treasury had considered a number of situations in which an exclusion for meals and lodging might be available and had determined to grant such an exclusion to both in-kind and cash items if the employer's convenience test were met. When studied in detail, these rulings show a progressive loosening of the employer's convenience doctrine as different situations were considered. The argument of analogy was more powerful and persuasive than the differences among the situations. Nowhere was there an attempt to elaborate the rationale of the various rulings in a cohesive fashion and to flesh out the meaning of the test for general application.

In opposition to the rulings allowing exclusions, the government persisted in its original ruling requiring inclusion of meals and lodg-

116. *Id.* (emphasis added).

117. *See* O.D. 915, 4 C.B. 85, 85 (1921) (hospital employees).

118. *See* O.D. 814, 4 C.B. 84, 84-85 (1921) (employees in fishing and canning industry).

119. *See id.* The ruling held that, as to employees of the Indian Service, the Department of Interior accounting procedures were determinative. Thus, if the Department treated the item as compensation, it was to be taxed as such. This gave effect to the implicit theory that the employer's handling of the item is determinative of the employer's convenience question, regardless of the facts and circumstances. The ruling also held, however, that the value of the meals and lodging furnished by the employer to a servant should be reported separately by the employer, implying that this amount constituted compensation income reportable by the employee. In many such instances, the employer might regard the employee's presence in the home as mandated by the nature of the services to be performed, but the employer's characterization of the item would not appear to have any bearing on its treatment. *See id.* at 84.

120. *See* O.D. 862, 4 C.B. 85 (1921) (parsonage furnished by congregation to clergyman). *See also* O.D. 915, 4 C.B. 85 (1921) (hospital employees).

ing in the income of Army officers presumably because they, unlike enlisted men, could choose where to live.[121] In 1925, this persistence led to the first consideration of the convenience of the employer doctrine by an American court in *Jones v. United States*.[122] The *Jones* court rejected the Treasury's position and granted an exclusion to an Army officer. *Jones* is the first in a long line of decisions that deal with the question of how the determination of employer's convenience is to be made. The court set out the rule as follows:

> If the nature of the services require[s] the furnishing of a house for their proper performance, and without it the service may not be properly rendered, the house so furnished is part of the maintenance of the general enterprise, an overhead expense, so to speak, and forms no part of the individual income of the laborer.[123]

Like the English case of *Tennant v. Smith*[124] before it, *Jones* relied on the example of seamen on board ship as a rationale for permitting the exclusion.[125] Thus, the question of the intent of the employer to compensate or not was insignificant; it was the general facts and circumstances of the employment that were determinative. This attention to the facts and circumstances surrounding the furnishing of the meals and lodging has come to be known as the "business necessity view" of the employer's convenience doctrine.[126] As can be seen, the judicial test did not differ significantly from the test used in the rulings referred to above.

The *Jones* case further held, with regard to the cash versus kind problem, that cash payments in lieu of the furnishing of quarters are also excludable.[127] In the 1951 case of *Van Rosen v. Commissioner*,[128] however, the Tax Court considered a cash allowance furnished to a civilian employee of the United States Army Transportation Corps, and refused to allow an exclusion on the theory that the freedom of disposition inherent in cash was sufficient to render its receipt taxable.[129] It is particularly interesting that the taxpayer's allowance in

121. *See* O.D. 921, 4 C.B. 86 (1921).
122. 60 Ct. Cl. 552 (1925).
123. *Id.* at 575.
124. 3 Tax Cas. 158 (H.L. 1892).
125. 60 Ct. Cl. at 575-76.
126. As to nonmilitary situations, see, e.g., Benaglia v. Commissioner, 36 B.T.A. 838 (1937) (reviewed by the Board).
127. 60 Ct. Cl. at 574. The IRS seems now to have completely accepted the application of § 119 to armed services personnel, including civilians. *See* Rev. Rul. 71-267, 1971-1 C.B. 37.
128. 17 T.C. 834 (1951) (reviewed by the Court).
129. *Id.* at 838.

Van Rosen, like that in *Jones*, was required to be paid by United States military regulation, but the cash/kind distinction was apparently determinative.[130]

The muddied waters that resulted from these varying judicial precedents as to cash versus kind, and as to employer's convenience generally, were not made any clearer by the Internal Revenue Service. In 1950, the IRS issued a Mimeograph declaring the convenience of the employer doctrine to be "simply an administrative test to be applied only in cases in which the compensatory character of [the furnished] benefits is not otherwise determinable."[131] The new IRS position was never further elucidated, but it seems to have signaled an intent to depart from the use of the employer's convenience doctrine to allow exclusions.

This confused state of affairs persisted until Congress sat down to write the 1954 Code. The resulting solution to the meals and lodging problem was section 119, which has continued to exist in approximately the same form to the present day. This section should "be construed as the draftsmen obviously intended it to be — as a replacement for the prior law, designed to 'end its confusion.' "[132] In large part, section 119 did exactly that by establishing very specific tests. But as everyone familiar with the litigation under section 119 knows, what Congress wanted ain't necessarily what Congress got.

First, there have been numerous decisions interpreting the meaning of the statutory term "business premises."[133] In addition, there

130. *Id.*

131. Mim. 6472, 1950-1 C.B. 15. This mimeograph was echoed in a Tax Court decision issued in 1953, Doran v. Commissioner, 21 T.C. 374 (1953). In *Doran*, the state employer's characterization of the item as compensatory was held to be determinative, despite the fact that the taxpayer was on 24-hour call. *Id.* at 376. Congress, in enacting § 119, affirmatively rejected any reliance on the employer's classification as determinative. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 19 (1954), *discussed in* Commissioner v. Kowalski, 434 U.S. 77, 91-93 (1977). *See also* Treas. Reg. § 1.119-1(a)(1) (West 1985) (meals), which applies the statutory and regulatory tests "irrespective of whether under an employment contract or a statute fixing the terms of employment such meals are furnished as compensation." *Cf. id.* § 1.119-1(b) (lodging).

132. Commissioner v. Kowalski, 434 U.S. 77, 93 (1977). *See also id.* at 90-91. For a general discussion of the confusion in pre-1954 law on this subject, see Comment, *Tax Treatment of Compensation in Kind*, 37 CALIF. L. REV. 638 (1949).

133. *See, e.g.*, Adams v. United States, 77-2 U.S. Tax Cas. (CCH) ¶ 9613 (Ct. Cl. 1977); United States Junior Chamber of Commerce v. United States, 71 T.C. 216 (1978), *aff'd*, 614 F.2d 398 (5th Cir. 1980); Lindeman v. Commissioner, 60 T.C. 609 (1973); Dole v. Commissioner, 43 T.C. 697, *aff'd per curiam*, 351 F.2d 308 (1st Cir. 1965); Frensley v. Commissioner, 44 T.C.M. 481 (1982).

Regarding state troopers, the definition of business premises has been interpreted broadly. *See* United States v. Barrett, 321 F.2d 911 (5th Cir. 1963) (every road and highway, and adjacent restaurants as well, constitutes the business premises of the employer, the state). *Accord* United States v. Keeton, 383 F.2d 429 (10th Cir. 1967); United States v. Morelan, 356 F.2d 199 (8th Cir. 1966). *But see* Wilson v. United States, 412 F.2d 694 (1st Cir. 1969) (highway roadside was continued need to resolve the cash versus kind question under the new statute as section 119 is silent as to the proper treatment of cash allowances. This issue was finally settled in *Commissioner v. Kowalski*,[134] where the Supreme Court held that the statute is intended to reach only items furnished in-kind.[135] But other minor issues continue to be litigated, such as whether direct billing of the employer for groceries is sufficient for "in-kind" meals.[136]

Collateral issues closely related to the issues presented by section 119 remain important. For example, it was not definitively settled until 1981 that the furnishing of meals and lodging to an employee does not constitute the payment of wages for purposes of the Social Security Act and its related provisions.[137] In addition, the Securities and Exchange Commission has expressed concern about the reporting of such items to stockholders as employee perquisites.[138]

Section 119 clearly permits an exclusion for more items than the administrative test used before its enactment. The major amendment to the section[139] since its enactment in 1954 shows greater congressional leniency in the previously unresolved area of spouse and dependent expenses. From litigated cases it is unclear whether prior Service policy required an allocation and inclusion of those items on the theory that the employer's convenience extended only to the ac-

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restaurants are not "business premises" of the state).

Cf. I.R.C. § 119(c) (1982), *added by* the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 195 (clarification of the meaning of business premises with respect to overseas camps).

134. 434 U.S. 77 (1977).

135. *Id.* at 94-95. *Cf.* Coombs v. Commissioner, 69 T.C. 426 (1976) (cash allowance excludable if paid for the express purpose of providing employees with meals at their worksites), *aff'd in part, rev'd in part*, 608 F.2d 1269 (9th Cir. 1979).

136. *See* Sibla v. Commissioner, 611 F.2d 1260 (9th Cir. 1980) (firemen's share of meal expenses excludable under § 119), *aff'g* 67 T.C. 870 (1977); 68 T.C. 422 (1977); Jacob v. Commissioner, 493 F.2d 1294 (3d Cir. 1974) (value of groceries furnished free to medical institute director held excludable). *But see* Tougher v. Commissioner, 51 T.C. 737 (1969) (grocery allowance not excludable), *aff'd per curiam*, 441 F.2d 1148 (9th Cir.), *cert. denied*, 404 U.S. 856 (1971); Rev. Rul. 77-80, 1977-1 C.B. 36 (allowance with which meals are prepared at home not excludable).

Recent general discussions of § 119 may be found in Kragen & Speer, *I.R.C. § 119: Is Convenience of the Employer a Valid Concept?*, 29 HASTINGS L.J. 921 (1978); Note, *Meal Reimbursements as an Employee Fringe Benefit*, 10 LOY. U. CHI. L.J. 789 (1979); Note, *A New Look at the Section 119 Meals and Lodging Exclusion*, 81 W. VA. L. REV. 483 (1979).

137. *See* Rowan Cos. v. United States, 452 U.S. 247 (1981). The *Rowan* result was codified by the Social Security Amendments of 1983, Pub. L. No. 98-21, § 327, 97 Stat. 65, 126-27 (1983) (amending I.R.C. § 3121). The question of whether fringes should be treated differently for income tax and for payroll tax purposes is discussed in Richmond, *supra* note 11.

138. *See* 42 Fed. Reg. 43,059-61 (1977); 43 Fed. Reg. 6060-65 (1978).

139. Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 205, 92 Stat. 3097, 3107 (1978) (amendment effective for taxable years beginning after Dec. 31, 1977).

tual employee.[140] But like the employee health benefit exclusion, this untaxed fringe has grown far beyond its working condition roots.[141]

The value of this fringe benefit to a given individual will vary, but it can be substantial.[142] This possibility should cut against the retention of the section 119 exclusion. Involuntariness does not warrant continuation of the exclusion as it may with respect to many medical expenses, nor can its continuation be justified on the ground that the meals and lodging are working conditions. A working condition exception is appropriate only when limited to items that are relatively small and that are difficult to value because of problems allocating them on a per employee basis.[143] Allowing an exclusion for meals and lodging is no different from permitting a deduction for other personal, nondeductible expenses such as commuting. In addition, there is good reason to believe that valuation of meals and lodging would be fairly easy in many instances, since the cash wage will be reduced in an amount that the employer thinks is appropriate to compensate for the room and board provided free of charge. Fair rental value can easily be established in most cases from readily available comparisons. In addition, allocating grocery costs is not overwhelmingly burdensome.

Finally, the existence of the section 119 exclusion has prompted recent attempts to expand its coverage to housing furnished to faculty and administrative personnel by schools and colleges. This argument comes in response to an announced IRS policy taxing the fair market value of such housing.[144] Expansion of the already overly

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140. *Compare* Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968) (remand required to determine if taxpayer's spouse and child were also employees) *with* Coyner v. Bingler, 344 F.2d 736 (3d Cir. 1965) (employee and wife required to live in building; exclusion allowed for the entire value of housing). The IRS's first published position regarding the spouse and dependent portions of the value of housing was found in Rev. Rul. 59-409, 1959-2 C.B. 48, holding that the value of meals and lodging supplied by a school to the employee's families was includable in the employee's income, but only one year later, without explanation, the ruling was revoked. *See* Rev. Rul. 60-348, 1960-2 C.B. 41.

141. The roots are reflected in the language of § 119 as it relates to lodging. Section 119(a)(2) mandates that the employee be required to accept the lodging "as a condition of his employment" in order for the exclusion to be available. I.R.C. § 119(a)(2) (West 1985).

142. *See, e.g.*, Adams v. United States, 77-2 U.S. Tax Cas. (CCH) ¶ 9613 (Ct. Cl. 1977) (fair rental value of "prestigious" house furnished by employer to executive employee living in Japan excludable under § 119 because it was necessary for the employee to live in plush surroundings to be effective in conducting business in Japan; some business conducted in home), *aff'd*, 585 F.2d 1060 (Ct. Cl. 1978).

143. *See infra* Part IV(B)(1).

144. *See* P.L.R. 8213005 (Dec. 21, 1982), in which the IRS held the differential between rents charged university employees and the fair rental value of the university-owned housing was includable in the employee's income and also constituted wages for purposes of FICA and FUTA. This ruling caused an uproar and resulted in the introduction of legislation making clear that the fringe benefit moratorium applied to these items. *See* Letter from Senator John

broad section 119 exclusion to include an even greater number of people is wholly unwarranted. Although education may well need additional subsidies, a direct form is better than such an indirect, backdoor approach.

7. Special Exclusions for Armed Services Personnel

Toward the end of the Second World War, Congress enacted two special exclusion provisions for armed forces personnel.[145] These were exclusions reenacted in the 1954 Code as sections 112 and 113. Under section 112 as it currently exists, members of the armed forces who are in active service are entitled to exclude "combat pay" received either while serving in a combat zone[146] or while hospitalized as a result of injuries or disease incurred or contracted on duty in a combat zone.[147] The amount of the exclusion varies depending on whether the person is an enlisted person, noncommissioned officer or a commisssioned officer.[148] In addition, section 112(d) permits an exclusion for Vietnam War veterans and civilian armed services employees during the Vietnam War who were designated as missing. They may exclude all compensation received during any month they

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Heinz to Commissioner of Internal Revenue Roscoe Egger (Sept. 22, 1982) referring to S. 2871 (introduced by Senators Heinz and Moynihan), *quoted in* 17 TAX NOTES (TAX ANALYSTS) 319 (Oct. 25, 1982).

The IRS's position is backed, of course, by well-established authority. *See, e.g.*, Bob Jones Univ. v. United States, 670 F.2d 167 (Ct. Cl. 1982); Goldsboro Christian Schools v. United States, 436 F. Supp. 1314 (E.D.N.C. 1977), *aff'd on other grounds on motion for reconsideration*, 43 A.F.T.R.2d (P-H) ¶ 79-868 (E.D.N.C. 1978), *aff'd by unpublished order*, (4th Cir. 1981). In both of these cases, the § 119 exclusion was unavailable mainly because the employees were not on 24-hour call and the homes were not actually part of the business premises. In the 1984 Act Congress once again indicated its intention to prevent further administrative activity until there has been a chance for further discussion of the issue of faculty housing. Section 531(g) of the Act forbids the issuance of regulations between December 31, 1983, and January 1, 1986. *See* JOINT COMM. ON TAXATION, *supra* note 2, at 865-66.

145. The exclusion presently codified as I.R.C. § 112 originated in the Revenue Act of 1945, ch. 453, § 141, 59 Stat. 556, 571 (formerly I.R.C. § 22(b)(13) (1939)). Section 113 refers to payments made pursuant to the Mustering-Out Payment Act of 1944, ch. 9, 58 Stat. 8, 9.

146. An area is considered a combat zone if it is so designated in an Executive Order by the President. *See* I.R.C. § 112(c)(2) (1982). Treas. Reg. § 1.112-1(j) (West 1985), provides that activities performed outside a combat zone are deemed performed in the combat zone if in direct support of military activities in such a zone and if performed under conditions which qualify such members for hostile fire pay under the Uniform Services Pay Act of 1963, § 9(a). 37 U.S.C. § 310.

147. The hospitalization period may not extend more than two years after cessation of combat activity in the combat zone in which the injury occurred. *See* I.R.C. § 112(a)(2) (1982).

148. Enlisted men and noncommissioned officers may exclude all of their compensation under § 112(a), while commissioned officers are entitled to an exclusion of only up to $500 per month under § 112(b). This distinction was held constitutional under equal protection principles. Bruinooge v. United States, 550 F.2d 624 (Ct. Cl. 1977).

were missing.[149] Section 113 excludes from income the mustering-out payments received by service personnel leaving the armed forces.[150] These are generally lump-sum items constituting a form of severance pay.

B. The 1954 Code as Amended (to 1983)

The next group of exclusions to be considered consists of those that have been enacted by Congress between 1954 and 1984. Prior to the late 1970's, when new provisions mushroomed, only one exclusion section was enacted by the Congress subsequent to 1954. Thus, the group of new exclusions is generally of quite recent origin. In addition, except for section 79, every post-1954 exclusion added prior to 1984 was without administrative precedent. When one looks at the growth of fringe benefit provisions in the second half of the 1970's from the perspective of the early 1980's, it seems apparent that Congress became aware that it could provide more fringes only *after* the Treasury issued its first Discussion Draft of Proposed Regulations in 1975.[151] Thus, the interaction of the Treasury and the Congress continues, but since 1975 it appears that the major congressional aim has been to flout the desires of the administrators.

It should be noted, however, that the Treasury proposals regarding the taxation of fringe benefits advanced in 1975[152] and again in 1981[153] did not purport to achieve any radical reforms. In large part, they represented a systematic statement of the existing practice in a number of areas. These proposals will be alluded to throughout this article, but an in-depth analysis of the proposed fringe benefit regulations is beyond its scope and may be found elsewhere.[154]

1. Group Term Life Insurance

In 1964, Congress enacted the exclusion provided by section 79 for

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149. "Missing" is defined in 37 U.S.C. § 551(2) (1982) and generally means a person who is a prisoner of war or missing in action.

150. Mustering-out payments are defined by Treas. Reg. § 1.113-1 (1960) as those payments made pursuant to 38 U.S.C. § 2105 (Act of Sept. 2, 1958, Pub. L. No. 85-857, 72 Stat. 1105, 1224), formerly § 5 of the Mustering-Out Payment Act of 1944, ch. 9, 58 Stat. 8, 9, and § 505 of the Veterans Readjustment Assistance Act of 1952, ch. 875, 66 Stat. 663, 690. Interestingly, while 38 U.S.C. § 2105 was repealed by an Act of June 24, 1965, Pub. L. No. 89-50, 79 Stat. 173, the regulations have not been amended to provide a different definition.

151. *See* Prop. Reg. § 1.61-16, 40 Fed. Reg. 41,118 (discussion draft), *reprinted in* [1985] 2 FED. TAXES (P-H) ¶ 7371.

152. *Id.*

153. *See* Prop. Reg. § 1.61-13, *reprinted in* [1981] II FED. TAXES (P-H) ¶ 70,181.

154. *See* Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141 (1976) (considers the 1976 proposals).

the employer's cost of purchasing group term life insurance.[155] The exclusion originated, however, much earlier than the enactment of the section suggests. The apparent reason for the original administrative exclusion was that no significant employee benefit was derived from the mere purchase of the insurance by the employer, the benefit derived therefrom being received only by the beneficiaries of the employee after her death.[156] The original IRS position was to include in the employee's income the premiums paid by the employer to purchase life insurance, as well as accident and health insurance. This was changed in 1920 with the issuance of Treasury Decision 2992 which excluded the employer's cost of group term life insurance from the employee's income.[157]

This position apparently continued until 1964, making section 79 somewhat unique in that it *reduced* the available exclusion to the employer's purchase of up to $50,000 worth of insurance coverage. But in determining the amount of the employer's contributions any amount the employee contributes is credited to the over-$50,000 portion first.[158] This significantly enhances the value of the employer contribution. The statute provides that only group term insurance qualifies under section 79 and that the permissible factors to be used in selecting the group should tend to preclude individual selection of key employees.[159] These requirements of the statute requiring nondiscrimination were strengthened in 1982.[160] The fact that there is a limitation to "term" life insurance means that there are no savings or other capital value features, as in whole life, accruing to the employee as a result of the employer's premium payments.[161]

2. Qualified Group Legal Services Plans

The first of the recent group of fringe benefit provisions is section 120,[162] which was designed to encourage employers to make available

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155. Revenue Act of 1964, Pub. L. No. 88-272, § 204(a), 78 Stat. 19, 36.

156. *See* Sol. Op. 1014, 2 C.B. 88 (1920). *See also* R. PAUL & J. MERTENS, FEDERAL INCOME TAXATION ¶ 7.05.

157. *See* T.D. 2992, 2 C.B. 76 (1920).

158. Treas. Reg. § 1.79-3(a)-(b) & (e) (West 1985).

159. *See* I.R.C. § 79(d) (1982).

160. *See* Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 244, 96 Stat. 324, 523-24.

161. The T.D. 2992 exclusion was for all premiums, regardless of the amount of insurance bought, but it did not include "group permanent" life insurance premiums. *See* Mim. 6477, 1950-1 C.B. 16.

162. I.R.C. § 120(e) was enacted by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2134, 90 Stat. 1520, 1926. For the legislative history of the section, see STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF TAX REFORM ACT OF 1976, H.R. 10612, at 668, *reprinted in* 1976-3 C.B. (vol. 2) 680; S. REP. No. 1236, 94th Cong., 2d Sess. 537,

to their employees access to low-cost legal services through prepaid plans. Although it is unclear what the previous position of the IRS was with respect to employer payment of employee legal fees,[163] it is safe to surmise that such practices were not widespread, particularly with respect to lower level employees. Section 120 thus accomplishes the social objective of making legal services more available. An interesting feature of section 120 is that this was the first fringe benefit exclusion provision for which Congress specifically set an expiration date when it enacted the original legislation. The so-called "sunset" for section 120 initially provided that it would not be applicable for taxable years beginning after December 31, 1981.[164] That limitation was extended by the Economic Recovery Tax Act of 1981 to taxable years beginning after December 31, 1984[165] and by the Tax Reform Act of 1984 to taxable years ending after December 31, 1985.[166]

The requirements for a section 120 exclusion are that the amounts be contributed by the employer to a "qualified group legal services plan," or that the legal services be provided by, or the reimbursement made through, such a qualified plan.[167] Employees, as well as their spouses and dependents, benefit from such a plan. The definition of "qualified plan" is lengthy, but in essence requires the plan to be nondiscriminatory as to the employees covered and the services provided.[168] In addition, a plan must follow certain notification procedures in order to qualify.[169]

3. Qualified Transportation Plans

At the height of the energy shortage of the late 1970's, Congress determined that it was good social policy to encourage employers to encourage employees to drive to work less. Thus, in the Energy Tax Act of 1978,[170] it enacted section 124 of the Code excluding from the employee's income the value of "qualified transportation" to and

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reprinted in 1976-3 C.B. (vol. 3), 404, 940.

163. *See* H. MACAULEY, *supra* note 9, at 176.

164. *See* I.R.C. § 120(e), *as enacted by* the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2134, 90 Stat. 1520, 1928.

165. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 802, 95 Stat. 172, 349.

166. Pub. L. No. 98-612, 98 Stat. 3180, extended the exclusion for group legal services plans to permit a longer period for the completion of the effectiveness study authorized by Congress when the provision was first enacted. *See* H.R. REP. No. 1050, 98th Cong., 2d Sess. (1984), *reprinted in* [1985] 2 STAND. FED. TAX REP. (CCH) ¶ 1191A.

167. *See* I.R.C. § 120(a) (West 1985); Prop. Reg. § 1.120-1(a), [1983] 2 FED. TAXES (P-H) ¶ 8703.4.

168. *See* I.R.C. § 120(c) (West 1985); Prop. Reg. § 1.120-2, [1983] II FED. TAXES (P-H) ¶ 8703.5.

169. *See* Prop. Reg. § 1.120-3, [1983] 2 FED. TAXES (P-H) ¶ 8703.6.

170. Pub. L. No. 95-618, § 242, 92 Stat. 3174, 3193.

from the workplace. Such "qualified transportation" must be furnished in an eight passenger "commuter highway vehicle,"[171] and the plan must not be discriminatory. In addition, the plan must specifically state that the transportation is furnished to the employee in addition to, and not in lieu of, compensation otherwise paid to the employee. Once again there is a sunset provision, with the exclusion available only for transportation provided before January 1, 1986. This provision, like the section 101(b) exclusion for employee death benefits, is slated for demise in the President's Tax Reform Proposal.[172]

It is interesting to note that Congress went to some length to indicate that the enactment of section 124 was in no way intended to imply that any other employer-provided transportation would be taxable to an employee.[173] Nevertheless, it has quite readily accepted at other times that such transportation will be taxable in certain instances.[174] The concern expressed by the Congress reflects the general debate over the taxation of nonstatutory fringe benefits.

4. Cafeteria Plans

The Revenue Act of 1978[175] provided for the most far-reaching fringe benefit exclusion ever enacted. Section 125 provides an exclusion for benefits made available under cafeteria plans, which offer employees a choice among various benefits, including cash. If the choice is made under a qualified cafeteria plan, an employee will not be taxed for choosing an otherwise nontaxable benefit simply because the employee could have chosen a cash option or some other taxable benefit instead.[176] Thus, this statute overrules an important branch of the doctrine of constructive receipt.

The exclusion for cafeteria plans generally does not extend to deferred compensation arrangements. Thus, a pension plan contribution is not permitted to be one of the choices of nontaxable bene-

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171. *See* I.R.C. § 124(b) (West 1985), which refers to tax definitions found in *id.* § 46(c)(6)(B).

172. *See* PRESIDENT'S PROPOSAL, *supra* note 4, ¶ 3.03.

173. *See* H.R. REP. No. 1773, 95th Cong., 2d Sess. 53-54, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 8071, 8082-83 (Joint Explanatory Statement of the Conf. Comm.).

174. The legislative history of the 1984 Act provisions on fringe benefits makes it clear that employer-provided transportation will be considered to be taxable if personal use of an "employer-provided road vehicle" is substantial. *See* Temp. Reg. §§ 1.132-1T Q/A 4 & 1.61-2T Q/A 11 to Q/A 20, 50 Fed. Reg. 7075 (1985). For earlier acceptance of this idea, see H.R. REP. No. 966, 93d Cong., 2d Sess. 159 (1974) (an examination of President Nixon's tax returns for 1969-1972 by the Joint Comm. on Internal Revenue Taxation).

175. Pub. L. No. 95-600, § 134, 92 Stat. 2763, 2783.

176. *See* Prop. Reg. § 1.125-1 Q/A 9, 49 Fed. Reg. 19,321 (1984), which explains that § 125 "provides an exception to the constructive receipt rules" under certain circumstances.

fits.[177] Otherwise, however, many of the fringe benefits already discussed qualify as nontaxable choices under a cafeteria plan.[178] One of the theoretical difficulties with the cafeteria plan approach is that making correct choices as to cash versus kind benefits requires a high level of sophistication as well as an ability to predict the future with relative accuracy, qualities few people possess in any great measure.

As with the provisions that have already been discussed, nondiscrimination requirements must be met in order for the plan to qualify. The nondiscrimination requirement here, however, is a two-level one. There may be no discrimination as to the nontaxable portion. In addition, there may be no discrimination as to the total benefits available.[179] The statute also provides that if the plan does discriminate in favor of "highly compensated individuals as to eligibility to participate, or highly compensated participants as to contributions and benefits," any person in whose favor the discrimination occurs will have to include in income any benefits received under the plan, including those that would otherwise be nontaxable.[180] This stiff nondiscrimination requirement was added by the 1984 Act in place of a rule that only required inclusion of an amount that exceeded the benefits available to others under the plan.[181]

As can be readily seen from the description of these provisions, the cafeteria plan has become an important feature of the fringe benefit landscape. Indeed, many employers took a fairly aggressive position in order to increase the attractiveness of their plans by adopting what are known as "flexible spending arrangements" or benefit banks. These enable an employee to receive amounts for expense reimbursement under, for example, a health insurance plan, without actually ever incurring the expenses. In the absence of regulations, a few employers felt that these flexible plans were valid under section 125. However, in February 1984,[182] the IRS issued an announcement,

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177. *See* I.R.C. § 125(d)(2) (West 1985) (as amended by the Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, 94 Stat. 3521, 3529).

178. *See generally id.* § 125(f). Nontaxable benefits include legal services, "qualified transportation," educational assistance, and health benefits. *See* S. REP. No. 1263, 95th Cong., 2d Sess. 74, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6761, 6837.

179. *See* I.R.C. § 125(c) (West 1985). On May 7, 1984, the Treasury proposed regulations that deal in part with the nondiscrimination requirement for cafeteria plans. Although the Tax Reform Act of 1984 later amended § 125 rather extensively, the amendments did not materially affect the nondiscrimination requirement of § 125(c) (the word "statutory" was added before "nontaxable benefits" each time the latter phrase occurred in the statute), and thus the proposed regulations should be considered to be valid with respect to the nondiscrimination rule. *See* Prop. Reg. § 1.125-1 Q/A 19, 49 Fed. Reg. 19,321 (1984).

180. I.R.C. § 125(b)(1) (West 1985). *See* JOINT COMM. ON TAXATION, *supra* note 2, at 869-70.

181. See I.R.C. § 125(b) (1982) as it read prior to its amendment by the 1984 Act.

182. *IRS News*, 22 TAX NOTES (TAX ANALYSTS) 687 (Feb. 20, 1984).

later formalized in proposed regulations issued in May,[183] that the cash in lieu of nontaxable benefit feature of these plans would prevent the plan from meeting the requirements of section 125. Although there was a storm of protest about the IRS's interpretation of the law, the propriety of that interpretation was confirmed by the congressional change in the definition in the 1984 Act to require that the benefits available under a section 125 plan be "statutory" nontaxable benefits. Nonetheless, Congress did bow to industry pressure by providing a rather comforting grandfather clause.[184]

Congressional awareness of the far-reaching impact of cafeteria plans on the availability of fringe benefits in the employment market caused the imposition of much stricter reporting requirements for such plans in taxable years after 1984.[185] In addition, the Treasury, in connection with the Department of Health and Human Services, was authorized to undertake a study to determine the impact of cafeteria plans which was to be completed no later than April 1, 1985.[186] Continued awareness of the need to scrutinize rising health care costs may well result in the imposition of benefit amount limits for all fringes, unless, of course, the lobbyists are successful in preventing such a result.[187]

5. Educational Assistance Programs

Enacted as part of the Revenue Act of 1978, section 127 provides a $5,000 maximum exclusion for educational assistance program benefits so long as the educational program of the employer qualifies under section 127(b).[188] The basic requirements of this section are threefold. First, the education must be provided for the exclusive benefit of the employees and not for dependents.[189] This distin-

183. *See* Prop. Reg. § 1.125-1 Q/A 14 & 15.

184. *See* I.R.C. § 531(b)(5) & (6) (West 1985), Pub. L. No. 98-369, 98 Stat. 494, 877.

185. *See* I.R.C. § 125(h) & § 6039D (West 1985) (added by the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494).

186. In August, 1985, the Treasury and the Department of Health & Human Services reported the flexible spending accounts were costing $12 billion per year in lost revenues. In addition, these plans were not containing the growth of health care costs. *Government Study Finds Cafeteria Plan Flexible Spending Accounts a Revenue Loser*, 28 TAX NOTES (TAX ANALYSTS) 868, 868 (Aug. 19, 1985).

187. The lobbyists may have considerable help from certain Senators. *See* Daily Tax Rep. (BNA), July 25, 1985, at G-6 (statement of Sen. Packwood). *See generally* Daily Tax Rep. (BNA), Oct. 7, 1985, at K-1 to K-4 (reports of unfavorable responses to changes in the fringe benefit law).

188. *See* I.R.C. § 127 (West 1985). For a general discussion of educational assistance plans, see Caplin, *Educational Assistance Programs: A New Fringe Benefit for 1979-1983*, 57 TAXES 75 (1979). *See also* Pub. L. No. 98-611, 98 Stat. 3176, which extended the life of the exclusion and imposed the $5,000 maximum.

189. *See* I.R.C. § 127(b)(2) (1982).

guishes these programs from educational benefit trusts that have generally been held taxable[190] and tuition remission programs of educational institutions that have been given nontaxable treatment under the 1984 Act that essentially confirms the pre-1984 administrative position.[191] Second, the education must not involve sports or hobbies,[192] unless pertinent to the business of the employer.[193] Finally, the educational assistance plan may not be part of a cafeteria plan.[194]

There are also nondiscrimination requirements for plans under which the benefits are nontaxable.[195] These requirements do not, however, prevent the program from requiring that a participant obtain a certain grade.[196] However, they do prevent the employer from limiting the benefits to persons who are seeking only postgraduate degrees.[197] The section also requires that assistance not be provided for transportation, tools, lodging and other related items.[198] Instead, the section limits excludable benefits to tuition, fees and books.

Although there was a proposal pending to permanently extend section 127 beyond its expiration on December 31, 1983,[199] that did not turn up in the 1984 Act. The Treasury opposed the legislation,[200] but was unsuccessful in defeating a later bill that extended the life of section 127 one more year.[201]

6. Dependent Care Assistance Programs

The last of the pre-1984 Act exclusions is section 129, added by the Economic Recovery Tax Act of 1981.[202] Section 129 excludes from the employee's income amounts paid or incurred by the employer to provide dependent care assistance under a qualified program. Section

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190. *See* Armantrout v. Commissioner, 67 T.C. 996 (1977), *aff'd per curiam*, 570 F.2d 210 (7th Cir. 1978).

191. Treas. Reg. § 1.117-3(a) (1960) provided for the exclusion of educational institution tuition remission programs from 1956 onward.

192. *See* I.R.C. § 127(c)(1)(B) (West 1985).

193. *See* Treas. Reg. § 1.127-2(c)(3)(iii) (1982).

194. *See* I.R.C. § 127(b)(4) (1982).

195. *See id.* § 127(b)(4) (West 1985); Treas. Reg. § 1.127-2(e) (1983).

196. *See* Treas. Reg. § 1.127-2(e)(2)(ii) (1983).

197. *See id.* § 1.127-2(e).

198. *See* I.R.C. § 127(c)(1)(B) (West 1985).

199. *See* S. 249, 98th Cong., 1st Sess. (1983) ("Employee Educational Assistance Extension Act").

200. Daily Tax Rep. (BNA), Apr. 29, 1983, J-8 to J-9 (statement by William S. McKee, Acting Deputy Assistant Secretary for the Treasury for Tax Policy, as a Hearing on Apr. 29, 1983, Senate Finance Comm. Subcomm. on Taxation & Debt Management).

201. Pub. L. No. 98-611, 98 Stat. 3176. The committee report accompanying Pub. L. No. 98-611 explains that the provision was continued for one more year to permit the completion of the effectiveness study by the Treasury. *See* H.R. REP. No. 1049, 98th Cong., 2d Sess. (1984), *reprinted in* 2 STAND. FED. TAX REP. (CCH) ¶ 1198W.

202. Pub. L. No. 97-34, § 124(e), 95 Stat. 172, 198.

129(e) defines dependent care assistance with reference to items considered dependent care expenses for purposes of the credit for dependent care under section 44A.[203] The plan under which the assistance is furnished may not discriminate in favor of highly compensated or upper-level employees or in favor of principal shareholders and owners.[204] Furthermore, the employee must be notified of the plan's existence.[205]

Although the definition of dependent care assistance is fairly broad, no exclusion is available for amounts paid by the employer to the employee's dependents or children under nineteen years of age.[206] This provision is clearly designed to limit abuses of the exclusion by parents attempting to shift income to lower income children or grandparents.

While Congress was vigilant to eliminate certain abuse possibilities in this area, it was not alert to a major problem with the exclusion. There is a maximum limitation on the excludable amount; it may not exceed earned income, or in the case of married couples, earned income of the lesser earning spouse.[207] However, there is no limitation on the cost of the care to the employer that will qualify for the exclusion. Under the section 44A dependent care credit, the limits on the creditable amount of dependent care are very low ($2,400 if there is one qualified individual receiving care and $4,800 if there are more).[208] Without any limits on the section 129 exclusion, these limits are essentially read out of the statute for persons whose employers provide dependent care assistance as a fringe benefit.

7. Summary

These exclusion provisions added to the Internal Revenue Code since 1975 have nothing whatsoever in common with provisions such as section 119 and the health benefit provisions which, despite their current breadth, have respectable origins in the generally accepted notion that conditions of employment are not taxable. As to the pre-1984 Act exclusions, their only rationale seems to have been that Congress wanted to encourage a particular social policy through the exclusion. Sometimes these policies were not of enduring importance or were misguided. In addition to their being substantively question-

203. *See* I.R.C. § 129(e)(1) (1985). Included are expenses for household services and for the actual care costs for a dependent person, as well as expenses incurred at a dependent care center. *See id.* § 44A(c)(2).

204. *See id.* § 129(d)(2) (West 1985).

205. *See id.* § 129(d)(6).

206. *See id.* § 129(c)(2).

207. *See id.* § 129(b)(1) (1982).

208. *See id.* § 44A(d).

able, there was little or no attempt by Congress to correlate these provisions with each other or with pre-existing fringes. Nor was there an attempt to determine their relative worth, either in terms of social policy or in terms of their relative cost in number of dollars of lost revenue.

C. 1984 Act Provisions

The Tax Reform Act of 1984 codified many existing fringe benefit exclusions that had been available in at least a few District Offices of the Internal Revenue Service prior to the effective date of the Act. In so doing, Congress intended to clear up confusion as to national policy concerning specific items (for example, free parking) and to codify certain stringent requirements for other items (for example, employee discounts).[209] Finally, section 61(a)(1), as amended, evidences congressional intent to treat fringe benefits as compensation and to exempt no fringe benefits other than those specifically excluded by provisions of the Code.[210]

The major change in the taxation of fringe benefits is in new section 132, where provisions excluding "no additional cost service," "qualified employee discount," "working condition," and "de minimis" fringe benefits can be found.[211] All of these are defined in careful and elaborate detail, raising the question whether these new provisions are administrable. It is, in any case, clear from the requirements for exclusion that Congress intends to prevent abuses in favor of highly compensated employees. There is a strict nondiscrimination requirement[212] and, in the case of "qualified employee discounts" and "no additional cost" services, there is also a requirement that the goods or services be available in the line of business in which the employee is performing services.[213] Although the Committee Reports indicate a clear awareness of the abuse possibilities available for executives, it is unlikely that the committee staffs anticipated everything that large companies will dream up in the way of nontaxable compensation packages.

In addition to the exclusions in the new Code section, Congress

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209. *See supra* note 2.

210. *See* I.R.C. § 61(a)(1) (West 1985), *as amended by* Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 877. Despite this statement, it is clear that Congress did not intend to require that items such as social security contributions and employee expense accounts should now be taxed.

211. *See* I.R.C. § 132 (West 1985).

212. *See id.* § 132(h)(1).

213. *See id.* § 132(b)(1) (as to no additional cost services); *id.* § 132(c)(4) (as to qualified employee discounts). Reciprocal arrangements among employers in the same line of business are permissible if the fringe benefit qualifies as a no additional cost service.

amended section 117, the scholarship provision, to codify a previously existing exclusion found not in the statute but in the regulations under that section. Although the prior exclusion had been interpreted to have rather broad coverage, including programs under which the tuition an employee paid to another institution was reimbursed by her employer,[214] the statute draws the lines for exclusion very carefully. It now permits an exclusion only for reductions in tuition for education below the graduate level.[215] The statute also imposes a nondiscrimination requirement that will undoubtedly make tuition remission less attractive as a fringe benefit for many educational institutions.[216]

Finally, the 1984 Act made a change in the income tax treatment of interest-free or below-market-rate-interest loans made in the employment context. Although the prior nonstatutory exclusion was unclear both as to its scope and as to its propriety,[217] Congress has now required the treatment of compensation-related below-market loans as income under section 7872. Below-market loans are those on which

214. *See* Treas. Reg. § 1.117-3(a) (1960).

215. See I.R.C. § 117(d)(2) (West 1985), which describes a "qualified tuition reduction" as one for education below the graduate level.

216. *See id.* § 117(d)(3). The legislative history of the nondiscrimination requirement makes it clear that not all employees need be covered by the plan. *See* JOINT COMM. ON TAXATION, *supra* note 2, at 861. For example, an educational institution could discriminate on the basis of a permissible criterion such as job description, "provided that the effect of the classification is nondiscriminatory." *Id.* The meaning of this language is opaque at best since it is clear that in most institutions all faculty members will be paid more than every other employee except top administrative personnel. *Cf.* J. EUSTICE, THE TAX REFORM ACT OF 1984, A SELECTIVE ANALYSIS ¶ 5.06[3][c] (taking the position that covering faculty and administrative personnel will not meet the nondiscrimination requirement).

Another curious aspect of the nondiscrimination requirement is how it ties in with the fact that remission (query whether reimbursement would qualify?) by other educational organizations is also excludable. It is likely that most colleges and universities that have reciprocal arrangements have them only for faculty and higher level administrators, but not for staff. It is hard to determine whether a tuition reduction obtained by the child of a faculty member at an institution other than the one at which her parent teaches would be under an arrangement that is "available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by an employer which does not discriminate in favor of . . . highly compensated employees." Reciprocity for faculty children only would presumably make the plan discriminatory.

217. Beginning with Dean v. Commissioner, 35 T.C. 1083 (1961), the Tax Court held consistently that loans with below-market interest rates did not give rise to income. *See* Beaton v. Commissioner, 664 F.2d 315 (1st Cir. 1981); Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Suttle v. Commissioner, 625 F.2d 1127 (4th Cir. 1980); Baker v. Commissioner, 75 T.C. 166, *aff'd*, 677 F.2d 11 (2d Cir. 1982); Creel v. Commissioner, 72 T.C. 1173 (1979); Zager v. Commissioner, 72 T.C. 1009 (1979). *See also* Hardee v. United States, 708 F.2d 661 (Fed. Cir. 1983). The general reasoning behind these decisions was that the taxpayer would have been entitled to an interest deduction for the additional interest that might have been imputed to her. This thinking ignores the restrictions on interest deductibility that have become an important feature of the statutory landscape. *See, e.g.*, I.R.C. §§ 163(d) & 265(2) (West 1985).

interest is payable at a rate which is less than the "applicable Federal rate"[218] if the loan is a demand loan,[219] or, if the loan is a term loan, loans on which the amount loaned exceeds the present value of all the payments due under the loan.[220] Under section 7877(a), foregone interest on a demand loan is treated as transferred from the lender to the borrower (as compensation in the case of a "compensation-related" loan) and then back to the lender as interest.[221] If the loan is a term loan, the amount of income will be the excess of the amount loaned over the present value of all payments required to be made under the terms of the loan. That amount will be income on the date the loan is made.[222] Since this provision prescribes a rather burdensome result, it is hard to imagine that any loans between employer and employee will not be structured as demand loans. Although "compensation-related loan" is defined broadly to include any below-market loan between employer and employee (and, incidentally, independent contractors and the people for whom they work),[223] there is a de minimis exception for loans where the outstanding balance does not exceed $10,000.[224]

One of the interesting things about these new provisions as they relate to low interest loans is what happens to the many loans that fall in the category outside the de minimis exception. While one can infer from the definition of "compensation-related" that Congress accepts the notion that all loans from employers to employees at a rate of interest below the applicable federal rate constitute compensatory arrangements, it is unclear how the below $10,000 loans will be treated under section 132. One can expect that some loans on which an amount of interest is foregone will come within the de minimis

218. I.R.C. §§ 7872(f)(1)(A) & (2)(B) (West 1985), the latter of which says that the "applicable Federal rate" for demand loans is the federal short-term rate in effect under § 1274(d). The proposed regulations set up a safe harbor for the interest rate on demand loans. *See* Prop. Reg. § 1.7872-3(c)(2).

219. The term "demand loan" is defined in I.R.C. § 7872(f)(5) (West 1985) to mean "any loan which is payable in full at any time at the demand of the lender."

220. *See id.* §§ 7872(e)(1)(B) & (2)(A). In order to determine the present value of all payments to be made under the loan, the applicable federal rate in effect under § 1274(d) is to be used and the interest is to be compounded semi-annually. *See* Prop. Reg. § 1.7872-14, 50 Fed. Reg. 33,553, 33,569-70 (1985), for examples of present value computations. A term loan is defined by § 7872(f)(6) as being "any loan which is not a demand loan."

221. *See* I.R.C. § 7872(a) (West 1985). For extensive treatment of demand loans and the computation of foregone interest, see Prop. Reg. § 1.7872-13, 50 Fed. Reg. 33,533, 33,568-69 (1985).

222. *See* I.R.C. § 7872(b) (West 1985); Prop. Reg. § 17872-7, 50 Fed. Reg. 33,553, 33,563-64 (1985). It is also possible that a below market term loan will be treated as having original issue discount under § 7872(b)(2).

223. *See* I.R.C. § 7872(c)(1)(E) (West 1985).

224. *See id.* § 7872(c)(3).

exception of section 132 as well as the de minimis exception to section 7872. Those that do not will undoubtedly not qualify for any other exclusion under section 132 unless, in some very limited circumstances, the no-additional-cost service rule were to apply to an employee of a lending institution with lots of extra loan funds available. Thus, it can fairly be said that Congress intends to tax almost all employment-related low interest loans as compensation.[225]

D. Nonstatutory Exclusions

As the law existed prior to the Tax Reform Act of 1984 it was occasionally difficult to document instances in which the Internal Revenue Service determined that certain fringe benefits were not subject to tax because many practices were not generally accepted even though they were widespread. There are still some exclusions that are not found in the statute and that seem to survive the 1984 Act. A minor one is the supper money exclusion, which first appeared in O.D. 514 in 1920. The legislative history of the 1984 Act accepts this exclusion as a de minimis fringe benefit under section 132(a)(4).[226] More significant continuing nonstatutory exclusions are accorded to employer funding of workers' compensation, unemployment compensation and Social Security. Finally, an important but rarely discussed fringe benefit, expense accounts for executives, still exists.

1. Social Welfare

Three different types of social welfare benefits have a fringe benefit element to them because the benefits themselves are funded wholly or in part by an untaxed employer contribution made on behalf of employees. These are Social Security, unemployment compensation and workers' compensation. They share the rationale that the benefits are paid as a result of need. They are also similar in that the benefits are either wholly or partially excludable from income. Although it may be theoretically appropriate to tax the employer contributions when made, the system of not taxing them is firmly entrenched, as a short description of the history of these fringe benefits will make clear.

Like the private pension plan contributions discussed above, the

225. The Treasury has permitted certain compensation-related loans that meet the regulations definitions of employee-relocation mortgage and bridge loans to be treated as being outside the coverage of § 7872. *See* Temp. Reg. 1.7872-5T(c), 50 Fed. Reg. 33,553, 33,561-62 (1985). In general, however, the Treasury has decreed that § 7872 will have very broad applicability. *See generally* Prop. Reg. §§ 1.7872-1 & -2(a), 50 Fed. Reg. 33,555, 33,556-57 (1985).

226. *See* JOINT COMM. ON TAXATION, *supra* note 2, at 858.

mandatory contributions made by employers under the Federal Insurance Contributions Act (FICA) are not includable in the income of the employees. The manner in which the Social Security tax is set up requires that employees contribute a certain percentage (5.7% for 1984-1987; 6.06% for 1988 and 1989; 6.2% for 1990 and thereafter)[227] of their incomes to a fund for old-age and survivors' insurance. An additional percentage of each employee's wages, equal to that contributed by the employee, is paid by the employer as an excise tax[228] and is deductible by the employer as a business expense.[229] The amount paid by the employee is deducted from her salary,[230] but that amount does not constitute a deductible expense for income tax purposes.[231] The maximum dollar amount of wages to which the tax applies has risen over the years and the current figure is $39,500.[232] The FICA tax enforces a system of savings for retirement and support for those already retired by mandating annual contributions to a common national fund.

To the extent that employer contributions go untaxed to the employee when they are made, the employee receives a double benefit. First, employees are better off than self-employed individuals for whom the FICA mandate can only be satisfied by their own earnings without a deduction.[233] Second, and in contrast to private pension plan contributions by employers which are eventually taxed to the employee, employer-made FICA contributions are not subject to tax in many instances because Social Security insurance payments are not includable in income unless they exceed a certain "base amount," defined in section 86(c) of the Code.[234] While it may well be socially proper not to tax the insurance benefits of retired individuals, even to the extent they are attributable to untaxed employer contributions, the unfairness of such a scheme vis-a-vis the self-employed is readily apparent.

227. *See* I.R.C. § 3101(a) (West 1985).

228. *See id.* § 3111(a).

229. *See* Rev. Rul. 80-164, 1980-1 C.B. 109 and Rev. Rul. 74-70, 1974-1 C.B. 116 regarding the timing of the deduction for such items and also for FUTA taxes.

230. *See* I.R.C. § 3102(a) (West 1985).

231. *See* Escofil v. Commissioner, 30 T.C.M. 578 (1971), *aff'd per curiam*, 464 F.2d 358 (3d Cir.), *cert. denied*, 409 U.S. 1112 (1972); Summers v. Commissioner, 30 T.C.M. 58 (1971).

232. *See* 42 U.S.C. § 430(c) (Supp. 1984).

233. *See* I.R.C. § 1401 (1954). This tax was added to supplement the FICA tax and extend it to the self-employed. *See* S. REP. No. 1669, 81st Cong., 2d Sess. 5-6 (1950), *reprinted in* 2 C.B. 302, 307-08 (1950). For taxable years beginning in 1989, a deduction for one-half of the section 1401 taxes will be available. *See* I.R.C. § 164(f) added by § 124(c)(1) of P.L. 98-21 (Apr. 20, 1983).

234. I.R.C. § 86 was added by the Social Security Amendments of 1983, Pub. L. No. 98-21, § 121, 97 Stat. 65, 80-84. Prior to 1983 no portion of Social Security benefits was subject to tax.

The exclusion for both contributions and insurance benefits has no statutory authority under either the Internal Revenue statutes or the Social Security Act.[235] In addition, a careful search of the legislative history of the original Social Security provisions[236] indicates no intent as to exclusion of these items from income taxation under the then-current Revenue Act of 1936.[237] Nevertheless, the Internal Revenue Service determined quite early that these social welfare benefits should not constitute income.[238] Initially, the intent of the Service was to treat benefit payments as excludable because they were similar to general welfare benefits paid by federal, state or local governments.[239] This analogy, however, is invalid to the extent that it ignores the compensatory origin of the contributions to which a part of the insurance benefits must be attributable and on which no tax had been levied. Nonetheless, the Service has always treated the contribution as excludable from income.

Thus, with respect to Social Security benefits the exclusions provided by administrative ruling amounted to a complete forgiveness of tax until 1983. In the Social Security Amendments Act of 1983,[240] Congress changed the complete forgiveness policy with respect to the social security benefits received. These are now taxed to the extent that they exceed certain levels. The inclusion in income is of only one-half of the benefit to the extent that "modified"[241] adjusted gross income exceeds $32,000 in the case of married individuals filing joint returns and $25,000 in the case of other individuals.[242] The difference between social security and privately-funded pensions remains quite clear. Presumably this difference is justified by the importance of retirement savings and retirement benefits as societal goals to be promoted through a government plan.

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235. The legislative history of the Social Security Amendments of 1983 supports the conclusion that no statutory authority exists for the exclusion. *See* H.R. REP No. 98-125, 98th Cong., 1st Sess. 23-24, *reprinted in* [1983] 11 FED. TAXES (P-H) ¶ 59,304, 59,304.23.

236. Act of Aug. 14, 1935 (Social Security Act), ch. 531, §§ 801-04, 49 Stat. 620, 636-37.

237. Revenue Act of 1936, ch. 690, 49 Stat. 1648.

238. *See* I.T. 3194, 1938-1 C.B. 114; I.T. 3229, 1938-2 C.B. 136; I.T. 3447, 1941-1 C.B. 191.

239. *See, e.g.*, Rev. Rul. 78-170, 1978-1 C.B. 24 (state payments to qualified individuals to reduce cost of winter energy consumption excludable); Rev. Rul. 74-153, 1974-1 C.B. 20 (state payments to adoptive parents for support and maintenance of adopted children excludable as general welfare benefits); Rev. Rul. 74-74, 1974-1 C.B. 18 (awards made by New York Crime Victims Compensation Board excludable); Rev. Rul. 57-102, 1957-1 C.B. 26 (benefits paid to a blind person under state public assistance law excludable).

240. Pub. L. No. 98-21, § 121, 97 Stat. 65, 80-84.

241. *See* I.R.C. § 86(b)(2) (West 1985).

242. *See id.* § 86(c). The includable amount is one-half of the Social Security benefits or one-half of the amount by which Social Security benefits plus modified adjusted gross income exceeds the base amount. The effect of this provision may in some circumstances tax the benefits at a rate exceeding 100%. *Id.* § 86(a)-(b).

As to unemployment compensation and workers' compensation there is no specific statutory provision for an exclusion. In addition, the IRS's acceptance of excluding the plan contributions is generally unarticulated. It has never been clearly stated that employer contribution to unemployment plans, whether they be private or government-sponsored, are not included in the income of the employees. Nevertheless, that seems to be the accepted treatment of the contributions despite the fact that the employer is entitled to a deduction under section 162 for the excise tax paid under section 3301 of the Code.

As to the benefits themselves, the tax treatment seems to be dependent on the source of the compensation paid. Generally, if the plan is funded by nongovernmental sources (for example, the employee's union), the benefits are includable to the extent they exceed the employee's nondeductible contributions to the plan.[243] If the plan is government-sponsored, the benefits are generally excludable within certain limitations.[244]

In 1978 Congress enacted the first limitation on the general exclusion of unemployment benefits from income.[245] Section 85 provides that if a taxpayer's adjusted gross income, plus unemployment benefits, exceeds a certain base amount,[246] an amount equal to fifty per-

243. *See* I.T. 1293, I-1 C.B. 63 (1922) (superseded in part by Rev. Rul. 71-70, 1971-1 C.B. 27).

244. *See generally* I.T. 3230, 1938-2 C.B. 136 (superseded by Rev. Rul. 70-280, 1970-1 C.B. 13). *See also* Rev. Rul. 55-652, 1955-2 C.B. 21 (extending I.T. 3230 to benefits paid pursuant to Title XV of the Social Security Act); Rev. Rul. 73-154, 1973-1 C.B. 40 (excluding payments made under the Emergency Unemployment Compensation Act of 1971); Rev. Rul. 76-63, 1976-1 C.B. 14 (excluding payments made under the Emergency Unemployment Compensation Act of 1974 and Title II of the Emergency Jobs and Unemployment Assistance Act of 1974); Rev. Rul. 76-229, 1976-1 C.B. 19 (excluding certain payments made under the Trade Act of 1974).

If, however, the recipient is being paid a fair market wage under the government program, the benefits will likely be included in income. *See* Rev. Rul. 63-136, 1963-2 C.B. 19 (on-the-job training payments made under the Area Redevelopment Act of 1962 or under the Manpower Development and Training Act of 1962 are excludable since they "are intended to aid the recipients in their efforts to acquire new skills that will enable them to obtain better employment opportunities"); Rev. Rul. 67-144, 1967-1 C.B. 12 (certain welfare payments intended to compensate for services performed by recipient held includable in gross income otherwise excludable); Rev. Rul. 71-425, 1971-2 C.B. 76 (welfare payments based on personal or familial subsistence requirements not includable in gross income; payments made intended to compensate for services includable); Rev. Rul. 74-413, 1974-2 C.B. 333 (for payments to be excludable, primary purpose of the program must be to train the participants, not to compensate them for work they performed).

245. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 112, 92 Stat. 2763, 2777.

246. The base amount is defined in I.R.C. § 85(b) (West 1985). It is generally $12,000 or $18,000 in the case of a joint return. These base amount figures were reduced from $20,000 and $25,000 by TEFRA. *See* Pub. L. No. 97-248, § 611, 96 Stat. 243, 706 (1982).

cent of the excess must be included in gross income.[247] This income-conditioned exclusion is designed to decrease incentives to remain unemployed and the consequent additional cost of government-sponsored programs.[248]

In the area of workers' compensation, on the other hand, there is a series of rulings from which it can be inferred that the IRS intends to exclude from income employer contributions to such plans.[249] These rulings deal with nonoccupational employee disability benefits and the scope of the exclusion for workers' compensation benefits under section 104(a)(1). They state that such nonoccupational disability benefits are not in the nature of the benefits intended to be excluded from income under section 104(a)(10). To the extent that the employer contributions to the plan were excluded from income, the benefits themselves are taxable.[250]

Section 104(a)(1) specifically provides an exclusion for benefits paid out of the state-maintained workers' compensation funds if the funds are used to pay for medical care.[251] To the extent a worker who has a job-related injury collects workers' compensation, the exclusion of this fringe benefit is a total one. This exclusion is similar to the one for employer-funded health insurance plans (which workers's compensation closely resembles) when the plan benefits are expended for medical care.

2. Miscellaneous

There is one nonstatutory exclusion for a fringe benefit that has received little attention in rulings, formal announcements of the In-

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247. *See* I.R.C. § 85(a) (West 1985). This provision was changed from the more complicated original by amendments in 1981 (Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 103(c)(1), 95 Stat. 172, 188) and in 1982 (Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 611, 96 Stat. 243, 706).

248. *See* H.R. REP. No. 1445, 95th Cong., 2d Sess. 48, *reprinted in* 1978-3 (vol. 1) C.B. 181, 222. The President's tax reform proposal and the Ways and Means Committee options both would tax all unemployment compensation as income. *See* PRESIDENT'S PROPOSAL, *supra* note 4, ¶ 3.06.

249. *See* Rev. Rul. 75-449, 1975-2 C.B. 43, *amplifying* Rev. Rul. 72-191, 1972-1 C.B. 45, *superseding* Rev. Rul. 257, 1953-2 C.B. 15, *modified by* Rev. Rul. 81-192, 1981-2 C.B. 50 (nonoccupational employee disability benefits are includable in gross income to the extent attributable to employer contributions not included in the employee's income).

250. *Id. See also* Rev. Rul. 79-147, 1979-1 C.B. 80.

251. *See* I.R.C. § 104(a)(1) (West 1985). For a discussion of § 104(a)(1), see B. BITTKER, *supra* note 16, ¶ 13.1.2.

Both the President's tax reform proposal and the Ways and Means Committee options would tax workers' compensation benefits to the extent they are not expended for medical care. *See* PRESIDENT'S PROPOSAL, *supra* note 4, ¶ 3.06. If these proposals become law, workers' compensation benefits will be treated on a par with health benefits under §§ 104, 105 & 106 as they are currently in effect (i.e., without a cap or other limitation on excludable benefits).

ternal Revenue Service, or in congressional deliberations. A valuable fringe available to many highly compensated employees is expense accounts and other items of business-related expense reimbursed by the employer to the employee. The manner in which the Code is currently administered guarantees a rather substantial fringe benefit as a result of reimbursed employee expenses so long as they are incurred in the employer's business.

It has long been clear that certain employer-reimbursed items such as the personal use of cars,[252] meals and lodging outside section 119 that are not related to the carrying on of the employer's business,[253] and the use of employer entertainment facilities beyond the time required for active business discussions,[254] are taxable as income. But other items such as one's own meal when entertaining a client, an expensive hotel room, first-class air travel and other well-regarded (by the restaurants, hotels and airlines,[255] if no one else) expense account items seem to be largely accepted as nontaxable fringe benefits.[256] To a great extent the reimbursement of travel and

252. See Prop. Reg. § 1.61-2T, 50 Fed. Reg. 7073 (1985), for an explicit statement of the Treasury position after the 1984 Act. As to pre-1984 case law, see Dole v. Commissioner, 43 T.C. 697, *aff'd per curiam*, 351 F.2d 308 (1st Cir. 1965); Whipple Chrysler-Plymouth v. Commissioner, 31 T.C.M. 230 (CCH) (1972); Rodgers Dairy v. Commission, 14 T.C. 66 (1950), *acq.*, 1950-2 C.B. 4. Such items may not, however, be wages subject to withholding. *See* CCH Ltr. Rul. Rpt. #223, Ltr. Rul. 8122017 (Feb. 24, 1981). *See also* JOINT COMM. ON TAXATION, *supra* note 2, at 838 n.68, where these cases are cited.

Prior to the 1984 Act, it was unclear whether such items constituted wages or compensation subject to the FICA and FUTA taxes and to income tax withholding. *See, e.g.*, Central Ill. Pub. Serv. Co. v. United States, 435 U.S. 21 (1978) (holding that in order for an employer to be liable for an employee's taxes on a given item of compensation (reimbursements for certain lunches), the employer's duty to withhold with respect to that item must be clear and precise); Ltr. Rul. 8122017 (Feb. 24, 1981) (holding, on authority of *Central Illinois*, that personal use by employees of employer vehicles did not constitute wages subject to withholding under §§ 3401 and 3401). As a result, the 1984 Act made numerous amendatory changes to insure that the treatment of such benefits as income under § 61 would be followed by consistent treatment for withholding and FICA and FUTA purposes. *See* I.R.C. §§ 3121(a), 3401(a) & 3501(b) (West 1985), *as amended by* Tax Reform Act of 1984, Pub. L. No. 98-369, § 531(d), 98 Stat. 494, 877. *See also* JOINT COMM. ON TAXATION, *supra* note 2, at 864-65, explaining these changes.

253. *See, e.g.*, Goldstein v. Commissioner, 73 T.C. 164 (1979) (VISTA volunteer); Weinberg v. Commissioner, 64 T.C. 771 (1975) (hospital resident).

254. *See, e.g.*, Gottlieb v. United States, 8 A.F.T.R.2d (P-H) ¶ 61-5142 (E.D. La. 1961) (boat); Standard Motors, Inc. v. United States, 8 A.F.T.R.2d (P-H) ¶ 61-5141 (E.D. La. 1961) (boat).

255. The most vocal objections to the Carter Administration proposals to limit the deductibility of "three-martini" lunches came from the restaurant industry, not from the businessmen whose luncheon styles might be changed.

256. *See* Treas. Reg. § 1.274-5(e)(2) (West 1985). This exclusion of reimbursed expenses has a long history. *See, e.g.*, T.D. 2079, 16 Treas. Dec. Int. Rev. 249 (1914) (allowing an exclusion for reimbursements for officers and employees of the United States).

Additionally, employer reimbursements do not constitute wages for purposes of withholding, FICA and FUTA. *See* Central Ill. Pub. Serv. Co. v. United States, 435 U.S. 21 (1978).

It has been estimated that limiting business entertainment deductions to 50% of the entertainment expenses is merely a thinly disguised method of paying personal expenses of upper-level employees. Some of the employer payments may be appropriately characterized as "working condition fringes" under new section 132 where the employer is satisfied as to their propriety, but certain personal items, such as the cost of one's own meal, should be taxable. Consideration of reform in this area is of greater importance following the enactment of the section 132 working condition fringe exclusion because of the lack of a nondiscrimination requirement in this context.[257] Although it would seem fairly obvious that there should not be a requirement that all persons must be treated the same as to the benefits received with respect to employer paid expenses, some rational limits should be placed on this fringe benefit. While the trend may be against large expense accounts for employees,[258] this fringe should not be ignored.

It is interesting to note that the other side of business entertainment — the benefit received by the person being entertained — is being viewed now by some as a fairly significant fringe benefit.[259] The difficulty of taxing these benefits to the employees (they are, after all, not furnished by the employer but rather by someone else) has produced suggestions that the deduction for business entertainment be further limited.[260] To some extent this notion animates the Treasury proposals for denying deductions for meals over a certain floor and for eliminating the deduction for tickets for professional sporting events, the theater and so on.[261] Such an approach may well be the only way to promote greater fairness with respect to these fringe benefits.

E. Summary

The current system of not taxing employee fringe benefits has proceeded in a piecemeal fashion with little attention to the policy questions for the various exclusions and with no attempt to justify each of them in terms of the others. This approach to lawmaking is

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amount spent would raise $.5 billion in 1984, $1.1 billion in 1985, and $1.2 billion in 1986. *See* Democratic Study Group, *Alternative Revenue Options, reprinted in* 19 TAX NOTES (TAX ANALYSTS) 77, 79 (Apr. 4, 1983).

257. *See* JOINT COMM. ON TAXATION, *supra* note 2, at 855.

258. *See Business Travel: Amenities Curbed*, N.Y. Times, June 15, 1983, at D4, col. 1. The story notes that many executives are now required to fly coach class on business and that companies are using computers to better track employee tendencies toward lavish expenditures of corporate funds. *See id.*

259. *See* Brannon, *The Business Entertainment Deduction*, 29 TAX NOTES (TAX ANALYSTS) 294 (Oct. 21, 1985).

260. *Id.*

261. *See* PRESIDENT'S PROPOSAL, *supra* note 4, ¶ 3.11.

not particularly sensitive to the needs of a logical tax system that would take into account many competing economic and social policy goals in defining the base. Given that conclusion, the most rational approach to dealing with taxation of fringe benefits would be to start over again. The Congress should reach conclusions about what benefits should be included in income, when they should be taxed and what amount should be taxable on a more rational and comparative basis. That is what the remainder of this article seeks to do.

III. Framework for Taxation of Fringe Benefits — Internal Revenue Code Section 83

In determining how a system of taxing fringe benefits would work as an alternative to the current patchwork of exclusions, two basic policy choices must be made. One concerns the proper timing of the inclusion of the fringe benefit in income, and the other concerns the amount that will be included once the timing problem is settled. One might suggest, for example, that the proper time to tax employer provided health benefits is when an unrestricted employer contribution to the health plan is made, rather than taxing them when the benefit is paid out. Another suggestion might be that the proper amount of income to the employee as a result of the employer contribution to the plan should be the fair market value of the contribution to the plan. Alternatively, the amount taken into income might be determined to be the employer's cost.

The mechanism suggested by this article for the inclusion of fringe benefits in income — using section 83 as the operative provision — involves clear choices on the questions of timing and amount of inclusion that are rooted in policy determinations. To the extent these policy determinations are related to the tax system, and hence inherently legal, they will be explored in the context of this part and in Part IV of this article. To the extent that the policy decisions are essentially social, political, or economic, they will be mentioned but not explored in depth.

Before going into a policy analysis, this part will analyze the use of I.R.C. section 83 in providing the mechanism for taxing fringe benefits. As will be seen from the following description, in 1969, Congress developed a comprehensive scheme for taxing compensatory property transfers that was specifically concerned with issues about timing and amount of inclusion, thereby attempting to create some clarity in one specific and troublesome area. Congress may well respond to the taxation of fringe benefits with a similar piece of legislation.[262] But sec-

262. It seems from the codification of most existing exclusion practices in 1984 that the

tion 83 is already available and, as the analysis that follows will point out, it represents a means of taxing fringe benefits without creating a new section of the Code.[263]

Although the history of section 83 reveals that it was intended to clear up problems in the area of the taxation of stock option and restricted stock plans,[264] its scope is not limited to these fringe benefits alone. The section is so broadly written that, without straining the language, it can encompass compensatory items other than the ones to which it was specifically directed. The courts have already chosen to apply section 83 to some fringe benefits,[265] and the Treasury recognized its general applicability to fringe benefits in the 1981 proposed regulations.[266] More recently, Congress mentioned section

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Congress is likely to do little to radically reform this area. Nevertheless, both the Treasury's initial proposal and the Bradley-Gephardt bill were designed to be more restrictive than the law prior to 1984. *See* Simon, *supra* note 4, at 1204-05.

One proposal that should not be forgotten was made to Congress in 1980, before the current vogue of modified flat tax proposals and as a way out of the then-existing moratorium. At that time the Tax Section of the American Bar Association passed a Legislative Recommendation that would add new § 128 to the Internal Revenue Code to provide for the treatment of current nonstatutory fringe benefits under a comprehensive scheme. Under that proposal, the value of "personal service benefits" received by an employee from an employer would not be included in income if:

1. The benefit was incident to the employer's trade or business, the marginal cost of providing the benefit was insubstantial, and the class of employees entitled to receive the benefit was not a discriminatory one;
2. the benefit was provided for the benefit of the employer;
3. the benefit, such as recreation, was one described in I.R.C. § 274(e)(5);
4. the benefit was of nominal value (as there defined).

Apart from these provisions, any benefit that was currently a nontaxable, nonstatutory fringe benefit would be subject to tax under I.R.C. § 83. *See* Committee on General Income Tax Problems, *Tax Section Recommendation No. 1980-1*, 33 TAX LAW. 993, 1005 (1980). The discussion accompanying the recommendation notes the general agreement of the recommendation with proposals of the American Institute of Certified Public Accountants (AICPA) and a Task Force of the Staff of the Joint Committee on Taxation. *Id.* at 1002.

The current position of the American Bar Association regarding fringe benefit taxation is along the lines of this earlier proposal. *See Hearings, supra* note 14, at 161 (statement of H. Bernard Aidinoff, ABA).

The ABA proposal is obviously at odds with the proposal made in this article. Nevertheless, despite disagreement as to the scope of exclusions from taxable treatment, the ABA proposal does recognize the validity of using current § 83 to tax benefits that do not come within the exclusionary provisions. This conclusion is in general agreement with the thesis developed more explicitly and in more detail here.

263. Other commentators also view the prospect of new legislation as bleak. Stanley Surrey believes the tax legislative process has "completely disintegrated" and has fallen into "utter chaos without responsible control residing anywhere." *See* Surrey, *Our Troubled Tax Policy: False Routes and Proper Paths to Change*, 12 TAX NOTES (TAX ANALYSTS) 179, 185 (Feb. 2, 1981).

264. *See supra* notes 40-66 and accompanying text.

265. *See infra* notes 283-318 and accompanying text.

266. *See* Prop. Reg. § 1.61-18; *supra* note 9.

83 in legislative history regarding the taxation of fringe benefits wholly unrelated to restricted stock transfers.[267] If necessary, the current application of section 83 could be expanded at the behest of Congress to specifically include currently nontaxable fringe benefits of all types.

It should be noted that the use of section 83 to tax fringe benefits, as is developed here, may accomplish no more as to the timing of the inclusion than the application of ordinary cash method accounting principles, augmented by the economic benefit and constructive receipt doctrines of section 61. Nevertheless, consideration of the use of section 83 is warranted because such an extension of section 83 would establish the sorts of restrictions that might be taken into account in deferring income. In addition, by using section 83 as the operative provision for inclusion, the fair market value is clearly the proper amount to be included in income. While this may create problems in certain instances, which are explored below, the decision to use fair market value as the measure of the amount of income has the merit of being the most theoretically defensible position. The issues as to the manner in which the statute would apply to fringe benefit items will be explored in this part.

A. *Section 83's Treatment of Compensatory Transfers of Property*

Outright compensatory transfers of property to individuals, which are not considered to be fringe benefits, have always been considered taxable. The Treasury's original position on "compensation not paid in money" was promulgated in 1918. If a "stipulated value of the service in terms of money" existed, the Treasury deemed such value to be the value of the "thing taken in payment," but if no stipulated value existed, the amount of compensation income was the "market or reasonable value of the thing taken in payment."[268] Where the transferred property was corporate stock, the 1918 regulations provided for a corporate deduction in the amount of the actual value of the stock, and the recipient had to include the same value as income.[269] This general rule has continued, largely unchanged, in the

267. *See* JOINT COMM. ON TAXATION, *supra* note 2, at 864 (requiring the Treasury to "issue regulations as soon as practicable and to the extent feasible, setting forth appropriate and helpful rules for the valuation of taxable fringe benefits, and coordinating the applications of sections 61 and 83").

268. Regulations 33 (Revised), art. 4, §§ 21-22, 20 Treas. Dec. Int. Rev. 130 (1919) ("Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash.").

269. *Id.* art. 139, 20 Treas. Dec. Int. Rev. 196 (1918).

regulations since 1918.[270] However, due largely to confusion surrounding the taxation of compensatory stock options and transfers of restricted stock, Congress decided in 1969 to enact a specific statutory rule governing the taxation of property transfers designed as compensation.[271]

1. General Rule of Section 83

Congress addressed essentially two concerns in section 83: First, the timing of the amount of income to be included as a result of a compensatory property transfer and, second, what effect restrictions imposed on access to the property should have on the timing and/or the amount to be included. Section 83's complicated language reflects its convoluted history, but states an essentially simple set of rules. When property is transferred in connection with the performance of services, the amount subject to tax is the fair market value of the property (not taking into account any restriction except one which by its terms will never lapse) less the amount paid for it (if any). The taxable event occurs "at the first time" the person having the beneficial interest in the property has full, unrestricted control of the property. This occurs when the property is not "subject to a substantial risk of forfeiture" or when the property becomes "transferable."[272] The taxable amount is included in the income of the person who performs the services, irrespective of who receives the property.[273]

2. Definition of Terms

a. Property

Section 83 applies to transfers of all types of property, real or personal. According to the regulations, however, it does not apply to money or promises to pay that are not funded and secured.[274] The reasons for the section 83 rule is fairly apparent with respect to money. If cash is received without restriction, it is includable in income at the proper time under the taxpayer's method of accounting.[275] On the other hand, if a taxpayer receives cash with restrictions

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270. *See, e.g.*, Treas. Reg. § 1.61-2(d) (West 1985).

271. *See supra* note 64 and accompanying text.

272. I.R.C. § 83(a) (West 1985).

273. For a general discussion of I.R.C. § 83, see Asimow, *Section 83: A Tale of Four Restrictions*, 15 Bev. Hills B.J. 543 (1981); Baker, *Restricted Property — Sec. 83*, Tax Mgmt. (BNA) No. 262 (1972 with Supp.); Johnson, *Stock Compensation under Section 83: A Reassessment*, 32 U. So. Cal. Tax Inst. 8-1 (1980); Metzer, *The Receipt of Property for Services*, 38 N.Y.U. 38th Inst. on Fed. Tax 24-1 (1980).

274. *See* Treas. Reg. § 1.83-3(e) (1978).

275. The taxpayer who receives an item of income under claim of right is generally re-

on its use, it may not be included in income under certain circumstances, on the theory that the taxpayer is either an agent for another[276] or merely a conduit.[277] Such an item will be includable if the restrictions lapse and it becomes available for use, or if the taxpayer appropriates the fund or a portion thereof.[278]

The receipt of an unsecured promise to pay is not subject to section 83 treatment because it is like an unmatured right to receive income in the future. As such, there will be no taxable event until the promise is either fulfilled[279] or is made more secure by written evidence of an obligation convertible to cash or otherwise susceptible of valuation. This exception to section 83 treatment appears to be applicable even in the case of rather sizable deferred compensation arrangements which exist by virtue of an employer's crediting an account on its books and which are not "qualified" under section 401.[280]

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quired to include it in income at the time of receipt under the doctrine of North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932). Application of this doctrine in the compensation area may be found in Healy v. Commissioner, 345 U.S. 278 (1953) and United States v. Lewis, 340 U.S. 590 (1951). A later restoration of item or a portion thereof will result in a deduction for the taxpayer in the year of repayment or at another appropriate time depending upon the method of accounting. Under certain circumstances, I.R.C. § 1341 will operate to relieve the taxpayer of any disadvantage resulting from the operation of the normal process of inclusion and deduction. *See* I.R.C. § 1341 (1982) (computation of tax where taxpayer restores substantial amount held under claim of right).

276. *Compare* Rev. Rul. 68-123, 1968-1 C.B. 35 (member of religious society acting as agent for her order not required to include in income amounts paid for her services by checks endorsed by her to the order) *with* Rev. Rul. 76-323, 1976-2 C.B. 18 (members of religious orders, not acting as agents for their orders, were taxed on wages even though entire amount minus living expenses was required to be endorsed to order).

277. *See, e.g.*, Stevens Bros. & Miller-Hutchinson Co. v. Commissioner, 24 T.C. 953 (1955) (one-half of profits which were received, but under contract made payable to another, not taxable to payee); Eagleton v. Commissioner, 35 B.T.A. 551 (1937) (same rule with respect to attorneys fees payable to another lawyer), *aff'd on other grounds*, 97 F.2d 62 (8th Cir. 1938).

278. *See, e.g.*, Rev. Rul. 71-449, 1971-2 C.B. 77 (contributions totaling $1,000 received by political candidate for use in campaign; candidate required to include in income $400 of that amount which was diverted to payment of his mortgage in year in which diversion occurred). *Cf.* Rev. Rul. 74-23, 1974-1 C.B. 17 (no diversion of funds for personal use and, therefore, no inclusion in political candidate's income).

279. *See, e.g.*, Jackson v. Smietanka, 272 So. 2d 970 (7th Cir. 1921) (right to additional commission did not occur ratably; it was taxable only when paid); Edwards v. Keith, 231 F. 110, 112 (2d Cir. 1916) (renewal commissions for sale of life insurance not taxable until received because "there is no certainty that the sum conditionally promised for an ensuing year will ever be paid. . . .").

280. *See* Rev. Rul. 60-31, 1960-1 C.B. 174, applying cash accounting principles to prevent current taxation of amount credited to unfunded deferred compensation plans but indicating that the doctrine of constructive receipt must be examined in all such cases. A House attempt to tax payments under such deferred compensation arrangements was rejected by the Senate. *See* S. REP. No. 552, 91st Cong., 1st Sess. 306-07 (1969), *reprinted in* 1969-3 C.B. 423, 502. The IRS attempt to tax certain deferrals which are made at the recipient taxpayer's option in 1975 Discussion Draft, Prop. Reg. § 1.61-61 [1983] II FED. TAXES (P-H) ¶ 70,0677, was blocked by the Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782-83.

Compensation by use of an unsecured note or other evidence of employer indebtedness is also included in this exception to section 83 treatment, despite the fact that receipt of a note results in income for the recipient in the amount of its fair market value under section 61.[281]

Examples of the application of the statute to a funded promise to pay money in the future may be found in cases dealing with educational benefit trusts, a fringe benefit arrangement under which employers contract to pay tuition at various educational institutions for a taxpayer's dependents. Under such plans, an employee initially receives merely a forfeitable right to a future benefit, which will not accrue until a child of the taxpayer attends an educational institution and the trust pays the tuition. Only when the promise to pay in the future is converted to money by a tuition payment or reimbursement does the right to the payment become nonforfeitable under section 83.

Although courts considering the matter have not examined directly the question of whether the receipt of the right itself constitutes a taxable event, they have applied section 83 principles in determining that a tuition payment by the trust is taxable to the employee.[282] The same result would presumably have been reached if the Tax Court, which originated the rule in *Armantrout v. Commissioner*,[283] had chosen to apply ordinary cash method accounting principles and the doctrine of constructive receipt, rather than section

281. *Cf.* Treas. Reg. § 1.61-2(d)(4) (West 1985), which provides that notes or other evidence of indebtedness given in payment for services constitutes income in the amount of fair market value. The proposed I.R.C. § 83 regulations had specifically provided that notes would be property for I.R.C. § 83 purposes. *See* Prop. Reg. § 1.83-3(e), 36 Fed. Reg. 10,789 (1971). This criticized provision, however, was not included in the final regulations. *See* COMMITTEE ON TAXATION, ASS'N OF THE BAR OF THE CITY OF NEW YORK, COMMENTS ON PROPOSED REGULATIONS UNDER § 83, at 40-41 (1971); NEW YORK STATE BAR ASS'N, REPORT OF THE COMMITTEE ON EMPLOYEE BENEFITS ON PROPOSED REGULATIONS DEALING WITH THE TREATMENT OF PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES 4 (1971).

282. *See e.g.,* Grant-Jacoby Inc. v. Commissioner, 73 T.C. 700, 710 (1980) (the Tax Court said that time of payment was the proper time for taxation "since petitioners did not have vested rights in the contributions made . . . to the trust"); Armantrout v. Commissioner, 67 T.C. 996, 1008 (1977), *aff'd per curiam,* 570 F.2d 210 (7th Cir. 1978) (the parties did not base their arguments on § 83, but the court felt compelled to "point out that [its] decision is supported by the specific language of section 83. . . ."). *See also* Rev. Rul. 75-448, 1975-2 C.B. 55 (holding the amounts paid taxable and the employer's deduction allowable in the year in which tuition is paid). *But see* Greensboro Pathology Ass'n v. United States, 698 F.2d 1196 (Fed. Cir. 1982) (amounts contributed to educational benefit plan of corporation currently deductible by corporation because plan resembled those described in Treas. Reg. § 1.61-10(a) more than § 404(a) plans; the only question presented concerned § 162 and not employee excludability).

The company that administers the plans involved in *Armantrout* and *Grant-Jacoby* had sought to enjoin the issuance of the revenue ruling but the suit was held barred by the anti-injunction act. *See* Educo, Inc. v. Alexander, 557 F.2d 617 (7th Cir. 1977).

283. 67 T.C. 996 (1977), *aff'd per curiam* 570 F.2d 210 (7th Cir. 1978).

83.[284] Support for the Tax Court's reliance on section 83 may be found in section 402(b), which deals with the similar matter of the taxability of contributions made by employers to nonexempt employees' trusts and which indicates that inclusion is to be determined "in accordance with" section 83.[285] Under the facts of the educational benefit trust cases, the alternative times for taxing the compensation to the employee would be either when the right is received or when the employer makes a contribution to the trust. But, at neither of these times does the employee have a matured and nonforfeitable right to a payment on her behalf.[286] The results in the educational benefit trust cases can clearly be applied to the taxability of other fringe benefits that are initially unfunded and unsecured promises to pay money or to transfer property in the future. Examples of these are the entitlement to employee discounts on goods and services, the analysis of which is developed in Part B, Examples 1 and 2.

b. Transfer

As defined in the regulations, the term transfer refers to the time at which "a person acquires a beneficial ownership interest" in property.[287] Presumably, this means less than complete beneficial ownership of property, because it is implicit in section 83 that a transfer of the property may occur before a taxable event for the recipient occurs. The regulations describe various factors to be considered in determining whether a beneficial ownership interest has been transferred. There must, for example, be a transfer of some risk of loss[288] in order for a transfer within the meaning of the statute to occur. Otherwise, the "transfer" is similar to an option to acquire property.[289] Although the grant of an option to acquire property may itself constitute a taxable event if the option has a readily ascertainable fair market value, a taxable transfer of the underlying property

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284. *Cf.* Rev. Rul. 80-300, 1980-2 C.B. 165, applying constructive receipt principles to an employer's stock appreciation right (SAR) plan. An employee would not be taxed upon receipt of the SAR's because they were subject to forfeiture, but she would be taxed upon exercise. *Id.*

285. *See* I.R.C. § 402(b) (West 1985). *See generally* B. BITTKER, *supra* note 16, at ¶ 60.3 (discussion of I.R.C. § 402(b)).

286. *See* Treas. Reg. § 1.83-3(c)(4), ex. (2) (1978). The related question of the timing of the deduction by the employer is considered in Grant-Jacoby, Inc. v. Commissioner, 73 T.C. 700, 710-16 (1980).

287. Treas. Reg. § 1.83-3(a)(1) (1978).

288. *See* Treas Reg. § 1.83-3(a)(6) & (7), ex. (5) (1978) for definition and example.

289. *See* Treas. Reg. § 1.83-3(a)(4) (1978). The IRS has indicated it will not issue rulings on whether a transfer has occurred for § 83 purposes if the amount received for the purported transfer involves a non-recourse obligation. *See* Rev. Proc. 81-10, 1981-1 C.B. 647. *See also* Treas. Reg. § 1.83-3(a)(7), ex. (2) (1978).

has not occurred.[290] If a requirement is imposed that property be returned under certain circumstances and if the consideration to be paid in such an event is minimal and bears no relationship to the property's fair market value, Treasury Regulations 1.83-3(a)(3) and (5) provide that such a requirement will be taken into account in determining whether a transfer of the property has occurred. Whether a transfer has in fact occurred is important to a recipient who wishes to elect inclusion under section 83(b) because the election is available only in the event of a transfer.

For example, an employer gives an employee a car to use for a year for business-connected travel by the employee and says that after the year the employee may have title to the car. The question is whether a transfer within the meaning of the statute occurs before the year lapses. Because no transfer of the beneficial ownership of the car occurs until the end of the year, the "transfer" of the car for section 83 purposes does not occur until then. The use of the car during the year solely for business purposes would presumably not constitute a taxable event under a reasonable rule excluding working conditions from income. If, however, the car were used for personal purposes, the value of such use during the year would be "transferred" and would be taxable under section 83(a).[291]

c. In Connection with the Performance of Services

By its terms section 83 applies only to service-connected transfers of property and has no application to gifts. It applies to all compensatory transfers whether for present, past or future services,[292] and it applies to transfers of property to independent contractors as well as to transfers to employees.[293] Using section 83 in the employee death benefit area should clarify any remaining issues with respect to such transfers, as they are clearly compensation for past services.

d. Transferable or Subject to a Substantial Risk of Forfeiture

Property transferred in connection with the performance of services may be subject to a variety of restrictions on its use or aliena-

290. *See* Treas. Reg. § 1.83-3(a)(2) (1978).

291. The current regulations define "property" for § 83 purposes in such fashion as to exclude use from the definiton. *See* Prop. Regs. § 1.61.2T(a), 50 Fed. Reg. 7073 (1985), for examples of the treatment of use. There is no logical reason why the right to use property cannot be treated as a property right in and of itself and thus subject to the rules of § 83. There would be no difference in treatment whichever section is the taxing provision.

292. *See* Treas. Reg. § 1.83-3(f) (1978).

293. *See* Cohn v. Commissioner, 73 T.C. 443 (1979); Cassetta v. Commissioner, 39 T.C.M. 188 (1979).

bility.[294] These restrictions may affect either the value of the property or the time when the transferee's rights in the property vest or both. The statute sets up two distinct classes of restrictions on property. These are "lapse" restrictions and "nonlapse" restrictions, the former important principally for timing the taxable event and the latter principally for determining the amount to be included in income.

Two types of restrictions fall within the definition of "lapse" restrictions, those which are substantial enough to defer taxation and those which are not. Only those lapse restrictions affecting "transferability" of the property or making it "subject to a substantial risk of forfeiture" are of the type which, if in existence at the time a transfer by the employer occurs, will result in postponement of the taxable event for the service performer. Any other "lapse" restrictions will not defer taxation nor will they be taken into account for valuation. If property is not subject to transferability restrictions and no conditions under which it might be forfeited exist, the taxable event will occur when the compensatory transfer occurs.[295]

A somewhat different situation arises when the property *is* subject to restrictions. For example, the employer gives the employee, as compensation, a car to use for three years and says that the employee may keep it until then and must use it for two years. The employer will transfer title to the employee at the end of the three-year period if she is still employed; otherwise, the car must be returned to the employer. Nevertheless, the employee is entitled, under the terms of the agreement with the employer, to give the car to her son after two years.

The regulations under section 83 lump the two significant lapse restrictions together by describing property subject either to transfer restrictions or to substantial risk of forfeiture as "substantially nonvested" property.[296] Practically, this use of one term to describe both kinds of restrictions is warranted. Property will be taxable to the person who performs services at the time when it is subject to no substantial risk of forfeiture, regardless of whether it continues to be subject to restrictions on transferability.[297] Property cannot be "transferable" within the meaning of section 83(c)(2) unless it is not subject to a substantial risk of forfeiture in the hands of the trans-

294. I.R.C. § 83(a) (West 1985).
295. *Id.* § 83(d).
296. *See* Treas. Reg. § 1.83-3(b) (1978).
297. *See, e.g.*, Sakol v. Commissioner, 67 T.C. 986 (1977) (stock still subject to transfer restrictions after lapse of a substantial risk of forfeiture; I.R.C. § 83 held constitutional), *aff'd* 574 F.2d 694 (2d Cir.), *cert. denied*, 439 U.S. 859 (1978).

feree.[298] Thus, the recipient of the property (whether the person who performs the services or some other individual) may well be able to assign, pledge, or give the property away.[299] The existence of a condition which constitutes a substantial risk of forfeiture to the transferee, however, will preclude the occurrence of a taxable event until the condition lapses.

Under the facts of the hypothetical situation, the employee will clearly have income at the time both restrictions lapse, that is, when title to the car is transferred. The question is whether the expiration of the restriction on transferability should render the car "substantially vested" and thereby trigger the taxable event at an earlier time. The answer depends on whether the car would have to be returned to the employer by the son if the employee leaves the job before receiving title to the car. If the son would be required to forfeit the car, then the taxable event is deferred. If the son would not be required to forfeit the car, the taxable event occurs when the employee gives the son the car, because the gift to the son eliminates the substantial risk of forfeiture. The meaning of "substantial risk of forfeiture" is thus central to the application of section 83 to any situation.

Section 83(c)(1) provides that requiring an employee to continue to render substantial future services to an employer prior to the vesting of property comes within the meaning of "substantial risk of forfeiture."[300] Whether the services required are "substantial" will depend on the facts of a given situation.[301] *Richardson v. Commissioner*[302] dealt with a forfeiture provision in an agreement deferring payment of compensation by contributions to a nonexempt employees' trust, made subject to the rules of section 83 by an amendment to section 402(b) in 1969.[303] The Tax Court held the provision did not constitute a "substantial risk of forfeiture" for section

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298. *See* I.R.C. § 83(c)(2) (West 1985).

299. Treas. Reg. § 1.83-3(d) (1978), which defines transferability by stating:

> [P]roperty is transferable if the person performing the services or receiving the property can sell, assign or pledge . . . his interest in the property to any person other than the transferor of the property and if the transferee is not required to give up the property or its value in the event the substantial risk of forfeiture materializes.

300. *See* I.R.C. § 83(c)(1) (West 1985).

301. *See* Treas. Reg. § 1.83-3(c)(2) (1978):

> [R]ights in property transferred to a retiring employee subject to the sole requirement that it be returned unless he renders consulting services upon the request of his former employer will not be considered subject to a substantial risk of forfeiture unless he is in fact expected to perform substantial services.

302. 64 T.C. 621 (1975).

303. *Id.*

83 purposes.[304] The provision in *Richardson* required the taxpayer doctor to render "advice and counsel" to the payor hospital after termination of his services so long as his health permitted.[305] It further provided that if he should "fail and refuse to render such advice and counsel, he shall, after the notice of said breach, forfeit all rights under this Agreement."[306] The Tax Court concluded there was no indication that the hospital would actually call on the doctor for "advice and counsel" in the future and that absent such an indication that the future services would be required, the statutory standard for deferring taxation was not met.[307] The court pointed out that "a practical rather than a formalistic test was intended."[308]

Another case, *Burnetta v. Commissioner*,[309] demonstrates the same general attitude toward insubstantial conditions.[310] The issue in *Burnetta* was the deductibility of employer contributions to a nonqualified pension plan.[311] The deduction was conditioned on the inclusion of the amounts in the gross income of the employees under section 83(a).[312] Although the amounts contributed were subject to forfeiture if an employee was dismissed for theft of company property or embezzlement, the Tax Court held the possibility of such an event too remote for the risk of forfeiture to be substantial.[313] Therefore, the employer was entitled to the deduction.

In effect, these cases ignore conditions that impose no real burden on a taxpayer's access to property. In so doing, they comport with congressional intent not to allow tax deferral on the basis of nominal restrictions that exist only for tax avoidance purposes.[314] Thus, in the case of fringe benefits, requiring restrictions be substantial and not remote in order for vesting to be deferred would generally result in current taxability of many items. For example, transfer restrictions attached to a parking permit given by the employer to the employee, or a permanent resale restriction on property purchased with an employee discount, would not determine the timing of the taxable event.

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304. *Id.*

305. *Id.*

306. *Id.* at 629. The agreement did not state what was to happen to the corpus of the trust, consisting of all the previously contributed amounts. *Id.*

307. *Id.* at 630-31.

308. *Id.* at 630, *citing* S. REP. No. 552, 91st Cong., 1st Sess. 122-23, *reprinted in* 1969-3 C.B. 423, 501-502.

309. 68 T.C. 387 (1977).

310. *Id.*

311. *Id.*

312. *Id.* at 403-05.

313. *Id.* at 4-5. *See also* Treas. Reg. § 1.83-3(c)(2) (1978).

314. The IRS has announced it will not issue rulings as to whether a restriction constitutes a substantial risk of forfeiture if the employee is a controlling shareholder of the corporation. *See* Rev. Proc. 81,010, 1981-1 C.B. 647.

The statute did not intend taking into account these types of transferability restrictions in deferring vesting and tax liability. They may be taken into account in valuation, however, if they constitute "nonlapse restrictions."

e. Restriction Which by Its Terms Will Never Lapse

"Nonlapse" restrictions imposed on property do not affect the timing of the taxable event, but may be taken into account in valuing the property to determine the amount includable in gross income. A restriction which by its terms will never lapse (otherwise referred to in the regulations as a nonlapse restriction) is by definition not intended to constitute a substantial risk of forfeiture.[315] The example found in the statute and regulations is a permanent requirement that stock transferred to an employee be sold or be offered for sale at a formula price, including a permanent right of first refusal at a formula price.[316] Such a restriction on a fringe benefit might arise if there is a permanent resale restriction on property purchased by an employee at a discount. Although such a restriction should not defer the taxable event, because it will never lapse, a reduction in value of the item purchased and, correspondingly, of the amount includable in income, could occur as a result of the restriction. Nonlapse restrictions are permanent restrictions on the use or transferability of the property, and are enforceable not only against the initial recipient of the property but also against transferees of the recipient of the property.

Nonlapse restrictions must be taken into account in valuing property. For example, the statute specifically provides a rebuttable presumption that, where a restriction sets up a formula resale price, that price is the fair market value of the property.[317] This rule seems fair and appropriate, because the reasons for the existence of nonlapse restrictions are by and large unrelated to tax considerations.[318]

3. Amount Includable in Income

a. If the Time for Inclusion Is When the Property Vests

In general, section 83(a) requires at the time of vesting the inclu-

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315. *See* Treas. Reg. §§ 1.83-3(c)(1), (h) & -5 (1978).

316. *See also* Ltr. Rul. 7943070 (July 26, 1979) (restrictive covenants held to constitute nonlapse restrictions).

317. *See* Treas. Reg. § 1.83-5(a) (1978) (formula price may at times not be determinative of value but will be a substantial factor). *See also* S. REP. No. 413, 91st Cong., 1st Sess. 88, 1969-3 C.B. 200, 255.

318. *See* H.R. REP. No 413, 91st Cong., 1st Sess. 88, 1969-3 C.B. 200, 255.

sion in income of the fair market value of the property transferred less any amount paid for it.[319] Determining fair market value is basically a factual matter. This may be difficult where the property is subject to restrictions, because many restrictions will reduce the property's value. For section 83 purposes, however, only a restriction which by its terms will never lapse is permitted to be taken into account in valuation. If the nonlapse restriction is a requirement of resale at a specified formula price, the statute provides in subsection (d)(1) that the price determined under the formula is deemed to be the fair market value of the property.[320] This is so unless the Secretary, who bears the burden of proof in this regard, proves to the contrary.[321] This statutory presumption gives little guidance, however, as to how other types of nonlapse restrictions should be weighted.

Recall the hypothetical of the employer giving the employee a car. If the employer imposed no restrictions on the employee's use of the car, the amount includable in income would be the fair market value of the car, say $5,000, at the time the car vests in the employee. If, however, the employer retains the right to purchase the car for $4,500 if the employee no longer desires to use it, then $4,500 would be the amount of includable income to the employee. This is so unless the Commissioner proves that such a restriction is ludicrous or that the value is actually $5,000 despite the employer's right of first refusal. If the employer restricted the employee's use of the car, for example, by not permitting out-of-state travel, that presumably would be insufficient to defer vesting. However, the restriction could affect the amount includable in income if it were a nonlapse restriction.

The major justification for the general rule of valuation in section 83 is that any alternative would permit a conversion of compensation income into capital gain. This would occur whenever the property's value did not decrease, and when largely unimportant restrictions were imposed in an attempt to reduce value and achieve this result. This justification is important with respect to fringe benefits such as restricted stock that have great value and are also subject to market fluctuations. It has limited importance, however, with respect to other fringe benefits.

Valuing property by the standard fair market value rule may be problematic. An adjustment will be required whenever property is sold at the discounted value or becomes less valuable prior to the lapse of the restrictions and is sold after they lapse. Whether the adjustment would be in the form of a capital loss or an ordinary loss

319. *See* I.R.C. § 83(a) (West 1985).
320. *See id.* § 83(d)(1).
321. *See* Treas. Reg. § 1.83-5(a) (1978) (valuation procedure).

has not yet been determined. By analogy to the current inclusion/subsequent deduction rule in the cash compensation area, the subsequent deduction should be for an ordinary loss even though it results from a disposition of property.[322] With regard to a subsequent forfeiture of property included in income when it becomes substantially vested, the Treasury has provided that a loss resulting therefrom is ordinary to the extent the basis of the property was increased as a result of a recognition of income.[323]

The statutory mandate to ignore lapse restrictions ought to reduce the number of cases alleging that the property transferred in connection with the performance of services has no ascertainable fair market value. Nevertheless, the statute and regulations admit to this possibility in determining the tax consequences of a receipt of an option, and state that the general rule of section 83(a) will not apply to an option without a readily ascertainable market value.[324] Whether such a rule will be developed with respect to the receipt of other kinds of property remains to be seen. An argument might be made that certain fringe benefits lack ascertainable value, but a de minimis rule should alleviate such problems if section 83 principles are applied.

b. If the Time for Inclusion Is When the Property Vests and an Amount Is Paid to Acquire the Property

Any amount paid to acquire the property subject to section 83 inclusion is subtracted from the amount includable in income. Such a situation might arise when an employee is entitled to purchase employer-manufactured items at a company store for a nominal amount. In such a case, the amount of income is the value of the discount.

If the amount paid for the discounted property is not paid in cash, but rather by evidence of indebtedness, the failure to pay cash may in some cases result in postponing the taxable event for section 83 purposes until the obligation is paid.[325] If notes are included in the

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322. The Second Circuit has suggested tht the taxpayer in such an instance would at least be entitled to a capital loss. Sakol v. Commissioner, 574 F.2d 694, 700 (2d Cir.), *cert. denied*, 439 U.S. 859 (1978). The capital loss theory is supported by Treas. Reg. § 1.83-2(a) (1978), which provides that a loss due to forfeiture of property, the fair market value of which was included in income pursuant to a § 83(b) election, is treated as capital if the asset is a capital asset. The loss would in any event be limited to the excess of the amount paid for the property over the amount received upon forfeiture. Treas. Reg. § 1.83-2(a) (1978).

323. *See* Treas. Reg. § 1.83-1(e) (1978).

324. I.R.C. § 83(e)(3) (West 1985). *See* Treas. Reg. § 1.83-7 (1978). This regulation applies to all options, not just employee stock options. It was issued in 1978 shortly after I.R.C. § 421 was repealed prospectively.

325. *See* Rev. Proc. 81-10, 1981-1 C.B. 647 (the IRS will not rule on whether a transfer has occurred for I.R.C. § 83 purposes if the amount paid for the purported transfer involves a

amount paid, the value of unstated interest is subtracted from the amount actually paid to acquire the property as are amounts paid for the use of the property or for other purposes.[326] A subsequent forgiveness or partial forgiveness of debt included in the amount paid for the property will result in an income inclusion for the year in which the cancellation occurs. Whether the item of income is classified as a cancellation of indebtedness amount or an amount of compensation has not been settled.[327] If the item is characterized as compensation, as it presumably should be, then the taxpayer will not have available the exclusion of cancellation of indebtedness income under section 108.[328] Furthermore, the basis of the property will not be adjusted under sections 108 and 1017 as it would be in connection with such an exclusion.[329]

4. Other Rules

In addition to setting out rules regarding timing and amount of inclusion in income, section 83 and the regulations thereunder attempt to provide a complete system with respect to compensatory property transfers.[330] Thus, an election can be made to include an item in income in the year of transfer even though it is not yet vested. This election has only limited applicability in the fringe benefit area.[331] Rules also exist regarding the effect of the transfer on the transferor of the property, the basis, and holding period of the property. The deduction rule is clearly important for fringe benefit compensation. The other rules discussed here are less crucial, but can become important if the fringe benefit is an item of tangible property and has significant value.

a. Effect on Employer

The availability of a deduction for a payor of compensation in the

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non-recourse obligation). *Cf.* Lo Bue v. Commissioner, 28 T.C. 1317 (1957) (on remand, the court held the taxpayer realized income upon giving notes for the purchase of stock rather than upon payment).

326. *See* Treas. Reg. § 1.83-3(g) (1978) (defining amount paid).

327. *Id.* § 1.83-4(c) states only that the amount is includable.

328. *See* I.R.C. § 108 (West 1985) (dealing with income from discharge of indebtedness).

329. *Id.* § 1017(a) (1982).

330. There are provisions regarding income from nonvested property (Treas. Reg. §§ 1.83-1(a)(1), -1(f), Ex. (1) (1978) and cancellation of nonlapse restrictions (Treas. Reg. § 1.83-5(b)(1) (1978)) that have only limited applicability to fringe benefits. There are also rules regarding the effect of arm's length (Treas. Reg. § 1.83-1(b) and (f) (1978) and gratuitous transfers (Treas. Reg. § 1.82-1(c) (1978)) that, again, having little, if anything, to do with taxing fringe benefits and are thus not described here.

331. *See* I.R.C. § 83(b) (West 1985). The manner of making the election is described in Treas. Reg. § 1.83-2(c)-(e) (1978).

form of transferred property under section 83(h) is predicated upon inclusion of the same amount as compensation income by the person who performed the services.[332] The deduction is, however, available only if the transferor of the property is the person who received the services and if the deduction is otherwise available under section 162 or section 212.[333] Section 83(h) thus creates a healthy tension between employer and employee in which competing tax considerations may have a beneficial effect. Because little difference exists between the top rate applicable to corporations (46%) and that applicable to individuals (50%), the discount to be applied to both is theoretically almost the same. As a practical matter the corporation may be paying tax at a much lower rate and the employee's deferral may be more valuable than an immediate deduction.

b. Basis of Property Transferred in Connection with the Performance of Services

Section 83 does not mention the basis of property to which it applies. Under section 1012 the basis is the cost in an arm's length transaction.[334] The regulations provide that the basis of substantially nonvested property in the hands of any person other than a person who has acquired it in an arm's length transfer must reflect the amount paid for the property as well as any amounts included in income.[335] Once property becomes substantially vested, the basis is increased to reflect any additional income inclusion. If the property is received by gift, any adjustments required under section 1015 will be reflected in the basis as will any section 1016 adjustments.[336]

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332. *See* I.R.C. § 83(h) (West 1985). This same rule exists with respect to stock options under Treas. Reg. § 1.421-6(f) (West 1985).

333. *See* I.R.C. §§ 162 (trade or business expenses), 212 (expenses for production of income) (West 1985). *See also* Treas. Reg. § 1.83-6(d)(1) (1978), which treats a transfer of stock by a shareholder to an employee as a contribution to the capital of the corporation by the stockholder allowing a deductible expense to the corporation at the proper time under § 83. Presumably this regulation was intended to reflect the holding in Deputy v. DuPont, 308 U.S. 488 (1940), and is supported by the section's legislative history. *See* S. Rep. No. 552, 91st Cong., 1st Sess. 123, 1969-3 C.B. 423, 502. Nevertheless, the provision was struck down as "clearly outside the scope of the statutory provisions of section 83" in Tilford v. Commissioner, 75 T.C. 134, 145 (1980). This holding was later reversed by the Sixth Circuit in Commissiner v. Tilford, 705 F.2d 828 (6th Cir. 1983). *See also* Webb v. United States, 560 F. Supp. 150 (S.D. Miss. 1983) (holding that there was a contribution to capital); Smith v. Commissioner, 66 T.C. 622 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979). *Cf.* Downer v. Commissioner, 48 T.C. 86 (1967) (shareholder received a capital loss when depreciated stock was transferred to an employee).

334. I.R.C. § 1012 (1982).

335. *See* Treas. Reg. § 1.83-4(b) (1978).

336. *See* I.R.C. §§ 1015 (basis of property acquired by gift and transfers in trust), 1016 (adjustments of basis).

c. Holding Period

The beginning of the holding period of section 83 property is geared, not surprisingly, to income inclusion under the statute. Under section 83(f), the holding period for substantially nonvested property begins immediately after the restrictions lapse and an amount is included in income under section 83(a).[337] When an election under section 83(b) is made, the regulations provide for a holding period beginning just after the date when the property is transferred.[338] As to purchasers in an arm's length transaction, the holding period is determined under rules provided in section 1223.[339]

B. Application of Section 83 to Specific Types of Fringe Benefits

The proposal to use section 83 as the mechanism for a more comprehensive scheme for the taxation of fringe benefits raises a few significant problems. Apart from the difficulty created by the regulation's definition of "property," the primary problems are those of timing and amount of inclusion. Essentially the same problems were present in other property transfers prior to the enactment of section 83. Assuming that the use of section 83 for fringe benefit taxation represents a sensible policy decision, of its application, three examples should be examined. The first is relatively straightforward in that it involves a transfer of tangible property, whereas the second two are less so in that they may involve no outright transfer of property in the narrow sense.

1. Example 1 — Employee Bargain Purchase of Refrigerator

In January, 1983, Elmer begins working for Icy Refrigeration, which manufactures refrigerators in Smalltown. Icy allows all employees to purchase refrigerators at cost plus ten percent for the less expensive models and at cost plus twenty-five percent for the more expensive models. The policy is restricted to current employees, each of whom may not purchase more than two refrigerators a year. In January, 1984, Elmer, who is married, purchases for his new home one of the "more expensive models" for $400. Such refrigerators ordinarily sell in the furniture store in his town for $700 and in discount stores in Big City, 200 miles away, for $600.

Applying section 83 to these facts reveals that the proper timing of the taxable event is not when the unfunded and unsecured promise to pay in the future is made (i.e., when the employment relation-

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337. *See* I.R.C. § 83(f) (West 1985).
338. *See* Treas. Reg. § 1.82-3(a) (1978).
339. *See* I.R.C. § 1223 (West 1985) (holding period of property).

ship between Elmer and the employer begins). Rather the taxable event occurs when Elmer exercises his rights under the promise and purchases the refrigerator in 1984. Although some clear benefit inures to Elmer from the mere promise that he may purchase the item, no basis for measuring the benefit exists until he actually makes the purchase.

The statute accomplishes this result by deferral of the taxable event until a substantial risk of forfeiture no longer exists. Such a risk exists in this instance because the opportunity to purchase at a discount is available only to current employees, and termination of Elmer's employment will terminate his right to make the purchase. Thus, the right to make the purchase does not vest until the purchase is made.

Deferral is appropriate for reasons of sound tax policy. Not only does deferral eliminate the extraordinary difficulty of determining the fair market value of the promise, but it also avoids the normal administrative difficulties arising when items are taxed before employees actually receive a benefit from them. Deferral is also in accord with the judicially developed claim of right doctrine that requires taxpayers to include income items only when they have clear title.[340] Requiring the income to be reported earlier would result in confusion as to timing of income in cases where the right is not firmly established and would not comport well with the system of annual accounting and the cash method.

Nevertheless, deferral does not overcome all of the valuation hurdles. Whenever products are sold in different markets, as in this example, considerable difficulty arises in selecting the market for determining fair market value. Because the lowest convenient retail market would be the one selected by most taxpayers, it seems the fairest one to use. Administrative difficulties could be dealt with by promulgating regulations stating that the amount includable under such circumstances would be the difference between the amount paid and the average lowest retail price at which the item is sold. While such a rule seems administratively manageable, it raises some obvious inequities due to its arbitrariness.

Although this example deals with a manufacturer, the rule would be the same if the employer were a retailer. Thus, in neither of those circumstances, with respect to tangible items, does the employer's cost determine the includable amount. The general market, not the market in which the taxpayer buys, determines the amount.

Under section 83, if Elmer had his employer transfer a refrigera-

340. North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932).

tor to a friend or family member, he would be taxed on the spread between amount paid and the fair market value of the refrigerator at the time that person bought the refrigerator at discount. The fact that Elmer disposes of the right to exercise his employee discount to someone else for cash does not alter the analysis. In such a case, he has simply managed to realize what would otherwise have been in-kind compensation in cash which should be taxed when received.

2. Example 2 — Airline Employee Discounts

Sammy Steward is an employee of Inter-American Airways. He lives in Los Angeles, but the flights he works are based in San Francisco. When space allows, Inter-American makes available to him the opportunity to fly free on any of its flights in the continental United States. The flights are available to Sammy by reservation if he pays half-fare. His spouse and any dependents also are able to fly on any of these flights for half-fare. In addition to these fringe benefits, Inter-American pays for Sammy's flights to and from Los Angeles so that he will be in San Francisco at the appropriate time for his scheduled working flights.

Accepting that the exercise of a right to use the employer's services below cost constitutes an item of property, the application of section 83 to these facts is relatively easy. As in Example 1, the proper time for the taxable event for Sammy is not when he is promised free travel to New York, but rather when he makes the trip. The same is obviously true of half-fare flights for his family. Thus, the results are the same under section 83 whether the fringe benefit is a tangible item manufactured or sold by the employer or a service furnished by the employer. If these items are made available to the employee below market price, the amount included in the income of the employee is the difference between the amount paid and the fair market value.

Although some difference exists between these obviously personal flights and Sammy's transportation between Los Angeles and San Francisco, the result is the same. The travel in question is essentially commuting, a personal and nondeductible expense for all employees, no matter how long the commute may be. Employer payment for this expense should result in income to the employee with no corresponding deduction for the employee. To hold otherwise would conflict with *Commissioner v. Flowers*.[341]

341. 326 U.S. 465 (1946). Mr. Flowers was a lawyer employed by the Gulf, Mobile & Ohio Railroad at its main office in Mobile, Alabama. Like our hypothetical Sammy, Flowers chose to live a substantial distance from the office for personal reasons. He sought to deduct the commuting expenses between the town in which he resided and Mobile under I.R.C. § 162, but the

The amount includable under section 83 is the fair market value of the airfare. With respect to the space-available trips, the amount would be figured on the standby fare. For the half-price and commuting trips, the amount includable should be the difference between what is actually paid and the lowest available coach fare.[342] Some obvious difficulties in valuation arise here, as in Example 1, where the items received are discounted in some markets and not in others. The rule of valuation suggested may appear inequitable in certain individual cases, but those should not prevent adoption of a relatively simple administrative rule.

3. Example 3 — Payment of Insurance Premiums by Employer

Edna Explorer is employed by Lost Ark Expeditions. Her job entails many hazardous trips to exotic lands. To provide for her safety and comfort in carrying out her duties, Lost Ark pays premiums on accident and health insurance for Edna. The only carrier that will write such insurance is Lloyd's of London, and the premiums are $3,000 annually, payable January 1 of each year. Although the policy covers Edna while she is employed by Lost Ark, should she leave Lost Ark's employ, Lloyd's will pay a refund to the company.

Applying section 83 to these facts, the first issue confronted is whether a "transfer" of "property" occurs upon payment of the premium. This is more than a simple transfer of money. A contract right is created in Edna and, when Lost Ark purchases an insurance policy in her name, a property right is transferred to her. The result might be more apparent if there were an actual physical transfer of the policy to Edna, but section 83 should not be interpreted in such a narrow, formalistic way when the policy is clearly safe from Lost Ark's creditors. Applying section 83 to these facts creates the same result as applying constructive receipt principles,[343] so this is clearly not a radical result.

The second question is whether a substantial risk of forfeiture exists in the terms of the insurance contract so as to defer vesting. The refund clause does not constitute such a risk. Her coverage is conditional on her employment, requiring a rendering of substantial future

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Supreme Court denied the deduction on the ground that the expense in order to be deductible must be incurred in the pursuit of business. *Id.* at 472. To give Sammy nontaxable income in the form of a free flight would amount to the same thing as giving Flowers the deduction he was denied. *See also* Hantzis v. Commissioner, 638 F.2d 248 (1st Cir. 1981).

342. *See* Prop. Reg. § 1.61-20(c), Ex. (4), [1983] II FED. TAXES (P-H) ¶ 70,181, at 70,182.5.

343. For a general discussion of this concept, see Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV. 525 (1974).

services within the meaning of section 83(c)(1).[344] For the period of her employment, however, she is fully covered, and the annual cost of that coverage is $3,000. If she quits and an amount were refunded to Lost Ark, she would have a lesser amount included. If the events were to span more than one taxable year, she might have a claim for refund or a deduction. Claim of right principles suggest these results.[345]

Again, the real problem is the fair market value of the contract right. The difficulties present in this example are inherent in all situations in which an intangible fringe benefit is purchased by the employer and then made available to the employee. In many cases the employer will be able to take advantage of certain economies of scale when purchasing the items in question. This is ordinarily true with group insurance plans when the employer pays the premiums. The existence of economies or, conversely, special circumstances increasing the cost to the employer, as suggested by the case of Edna and Lost Ark, must have some bearing on the amount included in the employee's income under section 83. But, a purchase by the employer should not always mandate using the employer's cost to determine the includable amount.

In the first example, which dealt with a manufactured, tangible item, equity seemed to demand that the includable amount be measured by the general market price of the item. The same might be said for large group insurance plans where the cost of the plan can reasonably be said to represent a general market price. In other words, the standard should be that employer's cost will be used as a rule of convenience for purchased intangible items where the number or amount of items purchased adequately establishes a market.

In circumstances where the number of items purchased is insufficient to establish a separate market, the rule of convenience would not apply and the general rule of fair market valuation would be used. How does that effect Edna? Presumably, under the test just stated, her includable income from the purchase of the insurance should be $3,000, if that is the amount that anyone would have to pay for this insurance. If the amount paid by Lost Ark is *greater than* the amount paid by others simply because of the insurer's experience with that company, Edna should include the lesser amount (fair market value) under section 83.[346] Such a rule would reflect the

344. *See* I.R.C. § 83(c)(1) (West 1985) (substantial risk of forfeiture).

345. For a discussion of the "claim of right" doctrine see *supra* note 275.

346. A case that stands for the proposition that the amount includable may be reduced if the employee values the item less than does the market is Turner v. Commissioner, 23 T.C.M. 952 (1964). *Turner* also suggests that another rule is more appropriate. *Turner* is, however, the

greater cost to the employer occurred because of *its* needs, rather than hers. If the rule were otherwise, i.e., if $3,000 were includable, both parties would be economically better off if Lost Ark were to pay her the cash and have her purchase the insurance herself, a suggestion they might or might not be willing to follow.

Issues of valuation also arise due to Edna's lack of choice in the matter. Despite some judicial expressions of concern,[347] the proper amount to be included in income should not be affected by what the employee is compelled to purchase with her compensation. After all, this was presumably part of the job description, and if Edna wanted the job but did not want to bear the cost of the tax on the insurance herself, she presumably could have bargained for more salary to ease the pain.

In addition to ignoring compulsion as a factor in valuing fringe benefits for purposes of their inclusion in the tax base, the fact that payment in-kind does not give the taxpayer cash with which to pay the tax liability should also be ignored. This article considers fringe benefits, and the taxpayer can ordinarily expect to have a certain amount of cash income from which the tax can be paid. This is essentially a matter that should be left to the bargaining table. Extreme circumstances may arise, as in the case of company towns,[348] where the value of the fringes is so great that the includable amount will exceed normal cash wages. These cases are, however, so rare as not to detract from the propriety of the general rule.[349] In addition, an argu-

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only case which so holds. Although other instances may exist in which such a rule should apply, such as for prizes, the employment relationship clearly should not be one of them. Some would accept the application of *Turner* in the compensation area. *See* New York State Bar Ass'n Tax Section, Committee on Employee Benefits, *Report and Recommendations on the Tax Treatment of Fringe Benefits*, 18 TAX NOTES (TAX ANALYSTS) 3, 9-10 (Jan. 3, 1983). The application of *Turner* outside the scope of the limited facts involved in the case might be unwise. Unlike compensation prizes are clearly not bargained for. The market could be established by looking at comparative purchases, but in some instances a market of one might exist. This would essentially be a matter of proof.

347. *See* Rudolph v. United States, 370 U.S. 269, 278 (1962) (Douglas, J., dissenting) (concern that payment of expenses while attending convention should not constitute income).

348. *See, e.g.*, Adolph Coors Co. v. Commissioner, 28 T.C.M. (CCH) 256 (1968).

349. If employees could not pay their taxes because so much of their compensation was furnished in-kind, employers would be forced to pay additional compensation in cash to enable the employees to meet their tax obligations. Employers would be pressured either through employee bargaining or through market forces into making such cash payments.

The Treasury has at times found the "perceived hardship" for employees receiving in-kind compensation too great to require the employee to pay the tax on the fair market value of in-kind compensation. Instead, the Treasury proposed an excise tax levied on employers (or, as an alternative, a disallowance of the business expense deduction for in-kind payments) on the value (allocated cost plus a fair return on that cost) of the fringe benefits provided in-kind. *See* *Hearings*, *supra* note 14, at 30-31 (testimony of John Chapoton), *reprinted in* 19 TAX NOTES (TAX ANALYSTS) 1193 (June 27, 1983).

The alternative suggested here would tend to cause the employer to bear more of the burment based on this type of consideration need only be carried to its logical conclusion to demonstrate its fallacy: persons successful in negotiating a compensation package including only "nontaxable" fringe benefits present the best argument in favor of a rule which would tax them.

A general rule, applicable to all funded promises to pay in the future, can be extrapolated from the example. The taxable event is the funding of the promise, either by paying for an item such as an insurance policy, an annuity, or a parking permit, or by self-funding the promise by contributing on an employee's behalf to a fund which will pay benefits in the future. Thus, a person will pay tax on the benefits received from having the fund made available even though the individual never makes use of it, i.e., is never sick. The foregoing logic would suggest the same result when the funded promise to pay in the future is a retirement plan. The illogic of a system that taxes currently the purchase of an annuity to furnish retirement security while exempting contributions to "qualified" deferred compensation plans adds support to this conclusion.

These three examples cover a range of various possibilities for taxing fringe benefits under section 83. The first and second examples deal with unfunded promises to pay and opt for inclusion when the employee's benefit is actualized. The third recognizes that when the employer makes a nonforfeitable financial outlay on behalf of the employee, inclusion should occur when the expenditure gives rise to the benefit. With respect to valuation, the general rule of section 83 would ordinarily apply, and the market would be that in which the general public purchases such items. In some circumstances, when the fringe benefit is an intangible benefit purchased by the employer, a rule of convenience is suggested which would use employer's cost when it seems properly, from an objective standpoint, to accord with market valuation. These three examples do not, however deal with the need to distinguish taxable fringe benefits from nontaxable working conditions. Nor do they consider the possibility of the need for a de minimis rule. Those issues and others regarding the policy aspects of this proposal will be developed in Part IV.

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den of taxation if the in-kind method of compensation is chosen. The focus on the employer, however, would be less direct than in the solution suggested by the Treasury. In addition, the appropriate measure of the amount of compensation to be accounted for is the fair market value of the item, and the Treasury's proposal simply fails to use that measure in its reliance on cost plus return. The Treasury's method of taxing fringes, proposed in part for its simplicity, is no simpler than the method proposed here.

C. *Additional Proposals*

Although the proposal to tax all fringe benefits under section 83 of the Code is complete unto itself, such a system may have certain drawbacks. Thus, two additional proposals are in order to complement that scheme of taxation and to reflect certain equitable and social goals.

Retirement savings plans occupy a special place in the tax system and may continue to require special rules under the scheme of taxation just explicated. Clearly, many members of society believe that only a tax system that tends to encourage retirement saving will adequately ensure that the most basic needs of older people are taken care of without resorting to wholesale state-sponsored programs for the retired. Accepting the idea that saving for retirement should be promoted, to propose an alternative to current exclusion in the form of a deduction for funds invested in qualified retirement plans seems appropriate. Adopting a rule lessening the burdens on employees suddenly required to pay tax on previously untaxed items may also be appropriate. An adjustment in the zero bracket amount is suggested as a means of accomplishing that result.

1. Deduction for Qualified Plan Contributions

The principal features of such a deduction should be these: it would be limited to an amount equal to a fixed percentage of income with a cap on the total dollar amount that can be contributed; the cap should be subject to increase as a result of inflation; and it should be available only for contributions to qualified plans available on a nondiscriminatory basis to all employees of a particular employer. Otherwise, employers would tend to compensate only executives and the deduction would not encourage the type of behavior intended. The deduction should be available for voluntary employee contributions as well as for employer contributions to a plan.

Another important feature of such a deduction is that the cap should be absolute. Employer contributions to plans in excess of the cap amount would be taxable income to the employee which could not be offset by the deduction. An additional employee contribution in excess of an employer contribution would be deductible only up to the amount of the cap. An overall limit of deductible plan contributions would also be imposed to prevent circumvention of the system by persons having numerous employers, for example, a number of divisions of the same corporation. This cap should be coordinated with the cap on self-employed earnings contributions so as to further eliminate complexity.

This system should prove easier to administer than the current myriad of exclusion provisions. The nondiscrimination requirements would have to be tightly drafted to ensure adherence to the purposes of the deduction without creating needless complexity in the description of the nondiscrimination rules. Such a rule would have the beneficial effect of eliminating the need for complex computations of contribution amounts for defined contribution plans. Instead, a capped percentage of the employer compensation figure would be utilized. Presumably the cap should be set high enough to allow flexibility in executive compensation. However, a significant discrimination between employer and self-employed plans creates undue burdens on tax administration, so the cap should be similar to that in effect for self-employed plans. Perhaps some compromise would be necessary to achieve relative parity.

As a corollary to the current taxation of employer contributions to the plans, determinations of how earnings on the contributed amounts should be taxed and the proper method of recovering the investment in the fund must be made. The present system of deferring taxation on fund income is perfectly adequate from a policy standpoint. Not only does that system tend to reduce complexity, it is comparable to the method of taxing annuity investments.[350] Preservation of neutrality disfavors discrimination between forms of retirement saving. Additionally, not taxing the income as earned encourages this form of saving. Indeed, no other incentive to invest in this type of plan exists apart from the deduction for the initial investment. One assumes that if the deduction is important, then deferring taxation on the earnings on the contributed amount is also important to society.

Finally, the proper system of basis recovery under this deduction plan involves two issues. First, it must be determined whether an upfront recovery of the investment, including the employer contribution, is more appropriate than some system of ratable basis recovery. Second, the fate of the deductible employer contributions must be addressed. Using ordinary cost recovery analysis, the contribution should not give rise to basis. If the employer contribution is deducted, that cost is recovered then and cannot be recovered again. Thus, with respect to amounts that are deducted, the changed method of retirement savings taxation would closely resemble the current system of taxing self-employed plans. The effect of taxing is simply deferred.

A system such as that for annuities could be used to recover pre-

350. *See* I.R.C. § 72 (West 1985) (annuities; certain proceeds of endowment and life insurance contracts); B. BITTKER, *supra* note 16, at ¶ 12.2 (discussion of I.R.C. § 72).

viously taxed contributions.[351] Otherwise, the investment could be spread as a percentage of each benefit payment in a manner similar to taxation of annuities prior to 1954.[352]

2. Increase Standard Deduction (Zero Bracket Amount)

While base broadening and increasing equity essentially demand the system of inclusion of fringe benefits in income, as suggested in this article, nevertheless sound reasons exist for lessening the harshness of such a radical change by making an across-the-board increase of perhaps $1,000 in the section 63(d) zero bracket amount.[353] Such an increase would ameliorate the burden imposed on individual taxpayers who benefitted from prior exclusions. In addition, the effect of the increase in the zero bracket amount would apply to everyone. This simple solution should have great appeal when considered in the context of this article. The reason for the increase in the zero bracket amount should not be forgotten, however. Once a change in the general direction of taxing fringe benefits was made, to begin enacting new and different fringe benefit exclusion provisions once again would be inappropriate.

IV. Policy Analysis

Having demonstrated the lack of systematic thought involved in the development of the current scheme of nontaxation of fringe benefits, as well as a possible alternative for taxing such items, the next question is why fringe benefits ought to be subjected to this new system. The main point of this article is that all fringe benefits should be taxed to employees under section 83 unless some weighty policy or administrative convenience reason exists for exempting them. This part of the article will explore that idea and propose some factors that should be considered in defining the taxable categories.

A. General Policy Reasons for Inclusion

Many believe that the broad-based exclusion of many fringe benefits from taxation creates significant problems for the tax system as a whole. Although most of these distortions have been addressed in considerable detail elsewhere, a capsule summary of the points generally made serves to demonstrate their importance in assessing the validity of this or any other reform proposal.

The first widely held belief is that the exclusions reduce tax eq-

351. *See* I.R.C. § 72 (West 1985).
352. *See* Internal Revenue Act of 1939, ch. 2, § 22(b)(2), 53 Stat. 1, 8.
353. *See* I.R.C. § 63(d) (West 1985) (defining "zero bracket amount").

uity. The detrimental effect on horizontal equity can be illustrated as follows. Compare a person (A) who receives a certain portion of her compensation in cash and the other portion in a selected number of fringes — for example, child care, health insurance, and employer-supplied recreational facilities — with a person (B) who is paid entirely in cash and must purchase those items in the open market with after-tax income. After purchasing the above-mentioned items, B has much less disposable income than A.[354] The perceived inequity can presumably be remedied by requiring that A pay tax on the items received tax-free from the employer.

Secondly, the difficulties presented by horizontal inequity resulting from untaxed fringe benefits are compounded by a different sort of inequity, the vertical inequity between taxpayers in different tax brackets receiving fringe benefits. Taxpayers are provided different amounts of benefit from untaxed fringe benefits that depend solely on the amount of income they earn. As with horizontal inequity, the existence of this disparity in benefit seems clear and is demonstrated elsewhere.[355]

Another important aspect of the inequity created by the nontaxation of certain fringes is the public sensitivity to inequities in the tax system in general. Although the extent of any publicly perceived unfairness in the tax system resulting from the tax treatment of various fringes has never been systematically analyzed, such a perception does exist. As a result, the social cost of continuing to allow broad exclusions for certain types of highly visible benefits may be too great to justify their existence. Though difficult to document, at some point the sense of the tax system's unfairness becomes sufficient to cause some otherwise law-abiding citizens to overcome scruples and fears about cheating. The issue of which fringe benefits should be taxed to undo either horizontal inequity, or vertical inequity or both should also be viewed in that context.

Statistics supply the final proof that distortions result from nontaxation of certain fringe benefits. These statistics show the magnitude of the annual "tax expenditure" resulting from the exclusion of each fringe benefit.[356] The figures may be staggering, but showing that a certain amount of revenue is foregone as a result of various exclusions merely states the obvious. Two compelling questions are, however, suggested by the statistics. The first is whether the failure

354. *See* Richmond, *supra* note 11, at 91.

355. *See* Popkin, *supra* note 11, at 449-51.

356. Tax expenditure projections for 1984-89 are available in 25 TAX NOTES (TAX ANALYSTS) 721, 727 (Nov. 19, 1984) (Table 1 contains tax expenditure estimates by function prepared by Joint Committee on Taxation).

to tax certain fringe benefits is so inequitable on a broad scale basis in the overall economy as to be unworthy of continuation. The second question is whether the exclusions are an inefficient way of accomplishing worthwhile goals. These two considerations illustrate the concern about the overall allocative inefficiency of fringe benefit exclusions. Thus, the belief exists that the tax system creates broad-based inequities between employees in industries for which the provision of fringes is either easy or fairly inexpensive, and employees in industries which do not widely utilize fringes. Statistics on tax expenditures resulting from fringe benefit exclusions suggest the direct expenditure approach might be both more fair and efficient.

B. *Possible Exclusions from Tax*

1. Working Conditions

As stated at the outset, the position is generally recognized that working conditions are nontaxable and that section 83 should not be interpreted to include such items in income. But, the meaning of the term "working condition" is subject to dispute. Thus, a generally acceptable definition of working condition which would result in only proper items being excluded from the tax base must be determined.

In 1981, the IRS defined working conditions in its draft of proposed fringe benefit regulations as "any item furnished by the employer either to enable or to facilitate the performance of employment services by the employee."[357] The definition is an acceptable starting place for discussion. However, further analysis is required because the regulations do not state the reason behind this definition.

The major rationale for a working conditions exclusion is that such items are provided by employers for noncompensatory reasons. Language to that effect would be a useful complement to the IRS definition.

Additionally, the business expense deduction area provides guidance in making the judgment as to which working conditions should be includable in income. This is essentially the same theory underlying the 1984 act definition of "working condition fringe" as "any property or services . . . to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167."[358] The phrase "other than items which are lavish or extravagant under the circumstances" should be added to the definition. Under such a rule, the executive or the movie

357. *See* Prop. Reg. § 1.61-18(a), [1983] II FED. TAXES (P-H) ¶ 70,181, at 70,182.1, defining "working condition." For further definitions, see *supra* note 9.
358. *See* I.R.C. § 132(d) (West 1985).

star who is provided with a car and driver by the employer for work-related transportation would not be taxed on the value of those services. On the other hand, that individual's secretary might be taxed on the same benefit. The working condition rule would not, however, exclude the fair market value of commuting in the same vehicle because that would not be related to facilitating the executive or movie star's employment services.[359]

Issues of administrative convenience and nondiscrimination also arise in the context of an exception to the general rule of includability for working conditions. To a certain extent, discrimination in benefits furnished would suggest that the perquisites are compensatory, but the rule should permit some differences depending on the status of the employee. Added language precluding lavish or extravagant expenditures would tend to facilitate proper distinctions as would the stated requirement of a noncompensatory purpose. Administrative difficulties in valuation and allocation are further justification for the exclusion of working conditions.

2. De Mimimis Rule

Another possible exception to the general rule of inclusion might be a de minimis rule for fringe benefits which, unlike working conditions, are only indirectly related to job performance. The scope of the exception is difficult to describe. Employer-provided recreation facilities are one example of where a de minimis rule could be useful.[360] An exclusion might be allowed for truly de minimis employee use of recreation facilities that the employer provides for carrying on its trade or business. For example, a manufacturer of sports shoes might have a testing track that it permits employees to use before and after business hours. But if the employer erects a special recreation facility for its employees, the employer should be precluded by section 83(h) from taking away deductions for the facility, such as depreciation, salaries for janitors, and water, unless and until the employees utilizing the facility include in income the value of the benefit they received.[361] Such a rule would impose on the employer the burden of

359. The proposal here is at odds with the "working condition fringe" exclusion in I.R.C. § 132(d) (West 1985), which would allow an exclusion for the entire value of an automobile so long as it was "provided primarily for the purpose of facilitating the employee's performance of service for the employer and substantially all of the use of the property" would be in connection with the performance of services.

360. *See* Committee on General Income Tax Problems, *supra* note 262 (proposed § 128(d) specifically refers to recreational benefits). *Cf.* Rev. Rul. 79-360, 1979-2 C.B. 236 and Ltr. Rul. 8323074 (Mar. 10, 1983) (recreational facilities and a general fitness program made available to employees did not affect the exempt status of a § 501(c)(3) organization).

361. An analysis of recreational benefits provided by employers and the need to distin-

keeping the necessary records required to properly allocate the benefit of the recreation facility among the employees who use it.

This example suggests that a de minimis exception would have to be quite limited. In order for the exception to apply, the employee fringe benefit would have to come about because of incidental use of employer services or property. The rule should not encompass situations in which the employer would not be entitled to a deduction with respect to an item unless the item is taken into income by employees.

3. Administrative Convenience

Then the question is whether any items should exist, in addition to working conditions and minimal fringe benefits, that ought to be excluded for reasons of administrative convenience because of the difficulty of valuation or otherwise. Given the scope of exclusions previously discussed, a separate administrative convenience exception does not seem necessary. A brief discussion of two candidates for such a rule will explain this conclusion.

One of the principal possibilities for exclusion on administrative convenience grounds is employee discounts on the purchase of employer products. New section 132 contains such an exclusion, although not for administrative convenience reasons,[362] and the IRS proposed such an exclusion in the proposed regulations.[363] The principal problem with both approaches is that they require valuation. If valuation is required, as good an argument exists for inclusion as for exclusion.

The answer is less clearly applicable to free parking, also excepted by the IRS on administrative convenience grounds[364] and by section 132 as a "working condition fringe."[365] If one assumes the employer is paying a personal, nondeductible expense on the employee's behalf, free parking ought to constitute income to the employee. Such a result would simply be an extension of the rule that both personal use

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guish among those benefits may be found in Guttentag, *supra* note 9, at 165-68. The distinction made therein between relatively small benefits and larger ones on the basis of whether the employer provides overnight accommodations makes a good deal of sense. In addition, as there noted, a nondiscrimination rule would be needed in this context so that large benefits made available only to executives would be taxed to the recipients.

362. The rules permitting the exclusion of "qualified employee discount[s]" are elaborate in the extreme and require valuation of the amount of the discount for purposes of determining whether the exclusion is available. This tends to suggest that administrative convenience was not a factor in granting the exclusion.

363. *See* Prop. Reg. § 1.61-19, [1983] II FED. TAXES (P-H) ¶ 70,181, at 70,182.2.

364. *See* Prop. Reg. § 1.61-19(b)(2), [1983] II FED. TAXES (P-H) ¶ 70,181, at 70,182.3.

365. Free Parking is treated as a "working condition fringe" under the special rule of I.R.C. § 132(h)(4) (West 1985).

of an employer's car to and from work and the trips between Los Angeles and San Francisco in Example 2 in Part III are taxable. Under this analysis, an example of rural employers who have vacant lots adjacent to their plants used by employees to park does not support excluding from income free parking in Los Angeles, where parking may cost as much as $200 per month. The employees who park in the vacant lot would presumably have no income anyway because the fair market value of the parking has value that would be either zero or de minimis.

On the other hand, location of the employer's business might have some bearing on whether the benefit of free parking is taxed to the employee. If so, the employer's decision to pay for parking in Los Angeles is simply a means of putting its employees in the same position they would be in if the place of employment were on the outskirts of Ventura. If the second line of thinking is the more appropriate one, then the free parking would be excluded as a working condition. In such a case, an administrative convenience exception to the general rule would not be necessary. This statement is not intended to resolve whether the value of free parking should be excluded, it is intended merely to indicate the proper way of treating such an exclusion.

4. Other Arguments

Finally, one must consider the propriety of changing the current scheme of taxation so radically at a time when certain fringe benefits have become a way of life, so to speak. This rationale for continuing any current exclusions is hardly persuasive because the possibility of grandfathering would produce unlimited complexity in an essentially simple proposal, and because such an approach to change seems unnecessary.[366] This article does propose an increase in the zero bracket amount to partially eliminate the economic burdens of such a change. Another suggestion might be to phase in the system over a ten-year period. But no grants of exclusion should be given simply because the particular fringe benefit has been nontaxable for a long time.

Finally, Congress may wish to further certain social goals through the grant of an exclusion for a fringe benefit. As this article suggests, a comprehensive analysis of all currently nontaxable items should be made on a comparative basis, and an attempt should be made to weight priorities of these tax expenditures against direct expenditures as well. Simply creating grandfather clauses for current exclu-

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366. *See generally* Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977).

sions would not satisfy this suggested overhaul of the system.

C. *Propriety of the General Rule*

This article suggests that fringe benefits of all sorts should be included in income under section 83 of the Code. The proposal thus has two essential parts: (1) That the amount includable in income be the fair market value of the fringe benefit, and (2) that the item be taxed when the benefit actually occurs. Any assessment of section 83 as the mechanism for taxing all fringe benefits must focus more on the amount of the inclusion rather than the timing. The use of fair market value presents significant issues besides administrative convenience. The rationale for the device will now be explored.

The conclusion that fair market value is the proper measure of the inclusion is based on two assumptions. The first assumption is that fringe benefits are compensatory in nature. The second is that fringe benefits reduce or should reduce the actual cash compensation paid to the employee in an amount equal or nearly equal to the value of the fringe. The amount of the cash compensation reduction will not always precisely equal the fair market value of the fringe benefit, however, partially because the actual value of the benefit to any given employee may be difficult to determine. In addition, a wide difference may exist between employer cost and employee value. If so, how the saving by the employer is shared is not clear. Nevertheless, rough parity exists between the reduction in cash compensation and the value of the fringe benefits received by an employee, and the makeup of a compensation package is dictated by each party's awareness of this fact.

Current bargaining between the employer and the employee is skewed because an additional factor is taken into account in the process, the nontaxability of fringes. The tax exemption makes them far more valuable to the recipient employee than cash income. The employee thus may be encouraged to opt for items that are nontaxable simply because they are unrealistically cheap compared to items purchased with after-tax income. This result tends to be inefficient both for the individual employee and for the economy as a whole because inefficient choices are encouraged in all bargained-for compensation decisions.[367]

The suggestion that section 83 be used as a mechanism for taxing fringe benefits is tax neutral as to cash or kind compensation in regard to the employee. With respect to the employer, the principal

367. J. STEUERLE, A PRIMER ON THE EFFICIENT VALUATION OF FRINGE BENEFITS. U.S. TREAS. DEP'T OFF. OF TAX ANALYSIS, PAPER 51 (1982).

disadvantage of using section 83 to tax fringe benefits, aside from obvious valuation and allocation difficulties, would be the deferral of deductions under section 83(h) when inclusion is deferred because an item is subject to a substantial risk of forfeiture.[368] This result could have a beneficial effect by encouraging the earlier vesting of benefits included in the compensation package. Symmetry between employer and employee treatment of the same item would be a dominant feature. Whether additional cash compensation or additional in-kind compensation would be paid would be governed only by the employer's ability to make the payment and the employee's bargaining power, not by the tax effect of the decision.

In addition to promoting greater efficiency in both individual choices and in the labor market, taxing fringe benefits under section 83 would tend to promote equity both horizontally and vertically. Belief in the fairness of the tax system, which today suffers from both real and perceived inequities, would also be increased. For these reasons, as well as the need to promote greater efficiency in the system, valuing fringe benefits at fair market value rather than at employer's cost[369] or at some other figure seems appropriate.[370]

Valuation is nonetheless a factor that needs to be taken into account. Taxing fringe benefits to employees in the amount of the employer's cost or, in the alternative, making the employer subject to an excise tax on the cost of the fringe benefits given to employees would remove a substantial valuation burden. In addition, an excise tax would relieve the employer of much of the burden of allocating the benefits to the employees according to use. A significant part of those burdens on the employer would be eliminated by the de minimis and

368. *See* I.R.C. § 83(h) (West 1985).

369. For a discussion of the merits of including the fair market value of fringe benefits in income, see Simon, *supra* note 4, at 1212-16.

370. Marginal cost plus opportunity cost has been suggested as the appropriate measure of the inclusion. *See* J. STEUERLE *supra* note 367, at 21(ff). The theory demonstrated by Steuerle is a more compelling one than the suggestion that the measure of the amount includable be limited to the employer's allocated per employee cost. *See, e.g.*, NEW YORK STATE BAR ASS'N, *supra* note 281, at 6-7. The New York State Bar proposal has been criticized because the allocated cost figure proposed there would actually result in a grater taxable amount for the employee than would incremental costs. *See* Letter of Sol Coffino, President of the Tax Executive Institute (TEI), to Roscoe Egger, then Commissioner of Internal Revenue (Nov. 1, 1982), *quoted in* 18 TAX NOTES (TAX ANALYSTS) 12, 12 (Jan. 3, 1983). The letter refers to the position taken by the AICPA in the proposal advanced in 1979, *Fringe Benefits: A Proposal for the Future*, that incremental costs be the measure.

See also Nolan, *Taxation of Fringe Benefits*, 30 NAT'L TAX J. 359, 362 (1977) (advocating fair market value as the appropriate measure; *Hearings*, *supra* note 14, at 30-31 (testimony of John Chapoton), *reprinted in* 19 TAX NOTES (TAX ANALYSTS) 1193 (June 27, 1983) (suggesting that "fair market value" is too difficult to determine, and, as an alternative, proposing an excise tax on employers or disallowance of employer business expense deductions for fringes, in either case using as value allocated cost plus a fair return on that cost).

working condition exceptions suggested above.

Some problems would nevertheless remain. A possible, and not altogether undesirable, result of taxing fringe benefits to employees at their fair market value could result in a substantial shift away from in-kind compensation because of the difficulties such a system would create for employers. Perhaps fringe benefits have indeed become such a "way of life" that the suggestion discussed here may be totally impractical.[371] On the other hand, impracticality does not make it incorrect in principle.

As to the timing decision inherent in section 83, the conclusion of current taxability again reflects the notion that fringe benefits are compensation and should be taxed as such when paid. Clearly, the benefits most affected by a change to section 83 timing would be pensions and other deferred compensation plans. Such a result would hardly be popular and would probably be politically infeasible, but the change suggested here could be made despite the fact that saving for retirement is regarded as valuable for society. Methods of encouraging such saving other than the current exclusion exist, among them the suggestion outlined in Part II-C, which provides a deduction for amounts contributed to qualified plans. If that suggestion were followed, taxing employer contributions to plans with vested benefits would simply shift the focus of the policy of encouraging saving for retirement to a deduction, which might be somewhat easier to administer. The conclusions may be somewhat different in the context of Social Security, unemployment insurance, and workers' compensation contributions. Although, in theory, government plans are no different from private retirement plans, sufficient political reasons may well exist to treat government plans differently from private plans.

One final consideration is that choosing to tax fringe benefits currently will avoid the transfer of tax liability to someone other than the employee taxpayer. This will frequently be true if spouses are divorced and the various benefits become part of a marital dissolution settlement. Another illustration of this aspect of current taxability concerns funded salary continuation plans that are taxable unless

371. Some of the practical problems with such a system are discussed in more detail in Simon, *supra* note 4, at 1212-16. Logic suggests that there is more political rhetoric to objections about the difficulty of implementing a system of taxing fringe benefits than anything else. It may well be, however, that the ordinary taxpayer would be willing to tolerate considerable unfairness in the system in order to preserve the nontaxable nature of certain benefits and that politicians are simply responding to what they perceive to be the sentiments of the general public. Certainly organized labor has seized on this as an issue about which it can seem to be doing something for the membership even though it is not clear that continuing nontaxable treatment of fringe benefits will achieve the best overall tax results for those whom the unions represent.

they come within the limited exclusion of section 101(b).[372] Taxing the employee rather than the surviving beneficiary is more appropriate because it is the employee who renders the services for which she is paid.[373]

V. CONCLUSION

This article has demonstrated a simple and straightforward method of taxing all fringe benefits under I.R.C. section 83. An historical analysis has demonstrated how badly the system needs reform. This article suggests section 83 as a method of taxing fringe benefits in order to eliminate the current complexities and inconclusiveness. Other proposals to deal with the nontaxation of fringe benefits might be helpful as well. Hopefully, this article will be seen as a first step toward informing the current legislative debates about the taxation of fringe benefits and toward persuading the Congress and the Treasury that fundamental change in the direction suggested is indeed necessary.

372. *See* I.R.C. § 101(b) (West 1985) (employees' death benefits).

373. To the extent the beneficiary receives amounts in excess of the employee's contributions, those amounts would be taxable to the extent they exceed the basis generated by the prior inclusion in income. This is, of course, assuming the earnings of the invested plan contributions are not taxed currently to the employee whose rights to them have vested. The reason for this result is the general notion of cost recovery. While it is true the rule suggested here does not assign the cost to the proper party, it is similar to the rule in the gift area prescribed by § 1015 basis. *See* I.R.C. § 1015 (West 1985) (basis of property acquired by gift and transfers in trust). In addition, there seems to be no alternative other than double taxation.