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UNITED THEY STAND, DIVIDED THEY FALL: PUBLIC CHOICE THEORY AND THE TAX CODE

Julie A. Roin†

Though ostensibly assessed on "all income from whatever source derived,"¹ it has long been obvious that the federal income tax base partially or wholly excludes many items which fit both a layman's and an economist's definition of income.² As a result, taxpayers interested in maximizing their after-tax gains expend considerable time and effort trying to fit their income producing activities or receipts into tax-favored categories.³ Congress allows and even encourages these tax minimization efforts.⁴ On the other hand, Congress imposes numerous barriers against their excessive use to prevent the wholesale erosion of the tax base. Some congressionally imposed barriers are straightforward and obvious while others are sufficiently subtle that they are often overlooked. This Article focuses on one such subtle barrier: the conditioning of a desired tax benefit on a relatively large number of taxpayers with disparate interests working together on a common tax minimization scheme. As a theoretical matter, achieving such cooperation will be difficult if not impossible, thus reducing the availability of the associated tax benefits.

This Article looks at two contexts in which this barrier to tax benefits is imposed, evaluates the relative successes and failures of

† Assistant Professor, University of Virginia School of Law. I would like to thank Hank Gutman, Saul Levmore, and Paul Stephan for their insightful comments on earlier drafts of this article. I am also indebted to participants in faculty workshops at the University of Virginia School of Law and Yale Law School. Finally, I owe special thanks to Craig Fishman for his research assistance.

¹ I.R.C. § 61(a) (1988). Unless specifically stated otherwise, all references to the Internal Revenue Code (the "Code" or "I.R.C.") hereinafter will be to the Internal Revenue Code of 1986, as amended November 1988.

² See D. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 3 (2d ed. 1984); W. KLEIN, B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 51 (7th ed. 1987).

³ For a history of tax avoidance devices and a description of their modern incarnations, see Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657 (1985).

⁴ Indeed, Congress enacted many of the special exclusion, deduction, and credit provisions of the Code to entice taxpayers to behave in ways that Congress considered desirable. OFFICE OF THE PRESIDENT, THE BUDGET OF THE UNITED STATES GOVERNMENT—FISCAL YEAR 1976 67 (Feb. 1976).

the barrier in those contexts, and speculates on the barrier's future utility as a limitation device. Part I, relying on principles of voting theory developed by economists working in the field of public choice,⁵ explains why requiring a group of taxpayers to work together on a common tax minimization scheme is an effective barrier against the success of the scheme. Parts II and III detail the history and current operation of group consensus rules in two parts of the Internal Revenue Code, and Part IV speculates on future applications of this anti-avoidance mechanism.

I

PUBLIC CHOICE THEORY

Public choice is the study of processes of aggregating individual preferences to reach group and social decisions.⁶ Public choice theorists grapple with two related problems. First, theorists seek a normative definition of "maximum social utility" or which social state ought to be chosen, given the individual preferences of voters.⁷ Second, theorists study the effect of actual procedures for aggregating individual preferences, and in particular, how well different voting rules serve the goal of reaching that social maximum.⁸

Although public choice theory was developed primarily to explain and evaluate political processes,⁹ in recent years it has also informed legal analysis. When applied to the deliberative processes of administrative agencies¹⁰ and courts¹¹ public choice principles explain why these institutions sometimes hand down decisions that are inconsistent with their own prior decisions. These principles also have served as the basis for attacking doctrines promulgated as guides for the resolution of future disputes by agencies and

⁵ "Public choice," "collective choice," and "social choice" are terms used to describe a type of economic and political science research into methods for making social decisions. A more complete description of this field of research is contained *infra* text accompanying notes 6-13. In the interest of avoiding confusion, this article only uses the term "public choice" to describe the field of research.

⁶ See Easterbrook, *Ways of Criticizing the Court*, 95 HARV. L. REV. 802, 813-14 (1982).

⁷ See D. MUELLER, PUBLIC CHOICE 2 (1979).

⁸ *Id.*

⁹ See, e.g., J. BUCHANAN & G. TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962) (applying public choice principles to decision-making rules in constitutional democracy); D. MUELLER, *supra* note 7, at 4 (noting that "many contributors to public choice have worked in or started from public finance"); R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 108-25 (3d ed. 1980) (applying public choice principles to the budgetary process).

¹⁰ See, e.g., Levine & Plott, *Agenda Influence and Its Implications*, 63 VA. L. REV. 561 (1977); Spitzer, *Radio Formats by Administrative Choice*, 47 U. CHI. L. REV. 647 (1980); Weingast, *Regulation, Reregulation, and Deregulation: The Political Foundations of Agency Clientele Relationships*, 44 LAW & CONTEMP. PROBS. 147 (1981).

¹¹ See, e.g., Easterbrook, *supra* note 6; Spitzer, *Multicriteria Choice Processes: An Application of Public Choice Theory to Bakke, The FCC, and the Courts*, 88 YALE L.J. 717 (1979).

courts.¹²

One of the most important contributions of public choice theorists has been the development of the "impossibility theorem": the idea that it is impossible to reach a predictable and stable social decision in situations where individuals, choosing among at least three different options, do not rank their choices among the options along a single spectrum, or in a "single-peaked" manner. In such situations, any one of several choices will be equally good (or bad); none will be "best."¹³ Obviously, the absence of a definitively "best choice" does not necessarily prevent any decision from being made, but the decision that is made will be controversial, in some sense counter-majoritarian, and therefore subject to challenge, review, and reform.¹⁴

To put the matter in a tax context, consider the dilemma facing an employer that, after learning about the tax benefits accorded employer-provided fringe benefits,¹⁵ decides to offer the next wage increase for its three employees in the form of a nontaxable fringe benefit. Assuming the employer is only willing to raise wages enough to cover the cost of providing one of three equally expensive benefits—health insurance, life insurance, or dependent care—how does the employer go about deciding which benefit to provide? The employer will be inclined to choose the benefit yielding the most satisfaction to its employees as a group.¹⁶ However, determining which of the three benefits best achieves this end is an impossible task if the employees prefer the various benefits in the rank-order described in the chart below.

¹² See Spitzer, *supra* note 10, at 682-87 (criticizing rules for review of changes in radio station formats); Spitzer, *supra* note 11 (criticizing admissions policy approved in *Bakke* decision and FCC licensing standards).

¹³ Stated in terms used by public choice theorists, where the individuals have "multi-peaked preferences," no choice will definitively generate a "maximum social utility" or "nonarbitrary result" for the affected individuals. R. MUSGRAVE & P. MUSGRAVE, *supra* note 9, at 111. Some commentators refer to this principle of decisionmaking as the "Arrow Theorem" in honor of Kenneth Arrow, whose proof of its validity in K. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1963) helped earn him a Nobel Prize. See, e.g., Easterbrook, *supra* note 6, at 823.

¹⁴ See D. MUELLER, *supra* note 7, at 224-26 (describing problem of reaching stable outcome on redistributive issues as "the infinite regress problem"); *id.* at 49 (prophesizing high "indexes of 'voter antagonism'" and "probability of cycles" when multi-peaked preference items at issue); Weingast, *supra* note 10, at 154 ("as long as new proposals can be made, majority rule choice has no natural stopping point").

¹⁵ These benefits, and the reason their availability entices employers to provide fringe benefits in lieu of cash salary, are explained in detail below. See *infra* notes 24, 32-38, 152-56 and accompanying text.

¹⁶ The more value employees attach to the benefit, the more cash salary such employees will be willing to give up in order to receive it, and the less expensive the total compensation package is likely to be. See *infra* text accompanying notes 155-56.

Table #1

<u>Employee</u>	<u>Health Insurance</u>	<u>Life Insurance</u>	<u>Dependent Care</u>
A	1	2	3
B	3	1	2
C	2	3	1

The instability or arbitrariness of any solution reached by submitting the issue to a vote by the affected employees demonstrates the central point of the "impossibility theorem." Assume a simple majority rule is utilized to determine the outcome with voting in a two step process. First, the voters compare one benefit to another and then they compare the survivor of that vote to the third benefit. Under this two step process, the "winning fringe" depends on the voting sequence: the order in which the benefits are paired and put to a vote. If the initial pairing is between life insurance and health insurance, health insurance wins in the initial pairing (preferred by A and C), only to be overcome by dependent care in the second pairing (preferred by B and C). If, on the other hand, the initial pairing is between health insurance and dependent care, dependent care prevails in the first pairing but life insurance is later the overall winner (preferred over dependent care by A and B). Finally, if the initial pairing is between life insurance and dependent care, the initial winner is life insurance, and the eventual winner is health insurance. No matter what the outcome, a majority of the employees will be dissatisfied because they prefer another fringe to the one that has been chosen. Presumably, these dissatisfied employees would lobby for a new "election" at the earliest possible opportunity. However, a new election will leave an equal number of employees dissatisfied, because once again, there will be no "best" choice. Rather, the winner of the next election, like that of the first election, will depend on the sequence in which the voting takes place.

The person or institution controlling the voting sequence (the "agenda") also controls the election's outcome.¹⁷ If the "control-

¹⁷ See D. MUELLER, *supra* note 7, at 45 ("if one voter can control the agenda at each step of voting 'he can construct an agenda which will arrive at any point in space, in particular his ideal point'"); Levine & Plott, *supra* note 10, at 589 ("[R]esearch suggests that processes commonly used to reach important decisions may be subject to a degree of agenda influence ranging from mild to surprising."); Weingast, *supra* note 10, at 154 ("[A]genda . . . plays a crucial rule in policy choice. Those with the power to manipulate the agenda gain considerable influence over final policy choice. . ."). On the strategic use of the agenda, see Plott & Levine, *A Model of Agenda Influence on Committee Decisions*, 68 AM. ECON. REV. 146 (1978). The mechanisms by which such control is developed and exercised have provided a fertile topic for public choice research. *E.g.*, Easterbrook, *supra* note 6, at 819-21 (effects of *stare decisis* on decisions of the Supreme Court); Weingast, *supra* note 10 (discussing "real world decision processes" subject to agenda influences such as run-offs and primaries, deliberations of administrative commissions and appellate courts and jury deliberations).

ler" has a preference for a particular outcome it can, and presumably will, impose that preference on the group. In the absence of a "controller," one would expect the outcome to vary randomly over time among the three alternatives. Because a majority of the employees will continue to be dissatisfied with the outcome of each election, this sequence of events will continue unendingly (and probably unpleasantly). In public choice parlance, a "cycle" will be generated.¹⁸ The cycle cannot be "solved" by altering the voting procedure to take into account employees' intensities as well as ranking of preferences, because employees who do not honestly state their positions can manipulate such a procedure.¹⁹

Prospects for employee satisfaction are no less bleak if the employer decides to impose a solution unilaterally, rather than to submit the issue to a vote. Any solution the employer imposes will be as vulnerable, and thus unstable, as an elected solution because no "right" answer exists. In essence, the impossibility theorem establishes that there is no proverbial "happy medium" in situations where the affected individuals have "multi-peaked" (as opposed to "single-peaked") preferences.²⁰

The impossibility of reaching a "best" solution does not necessarily mean that in all circumstances the employer will decide against granting any tax-favored fringe benefits. However, under certain circumstances, the employer will opt to provide only cash compensation. Such an outcome benefits the federal treasury because cash salary, unlike fringe benefits, is taxable income.²¹ It is, therefore, especially interesting that the Code's rules providing for the tax-favored treatment of fringe benefits tended to create circumstances in which the impossibility theorem applies—in short, the Code operated to minimize revenue loss by exploiting the effects of the impossibility theorem. What is even more interesting is that the major tool for achieving this end was a set of nondiscrimination rules ostensibly designed to broaden taxpayer access to tax-favored fringe benefits.²² The next section discusses how the nondiscrimi-

¹⁸ See Weingast, *supra* note 10, at 154 (pervasive cycling).

¹⁹ See D. MUELLER, *supra* note 7, at 198-99 (procedures in which intensity of preference taken into account "vulnerable to strategizing"); R. MUSGRAVE & P. MUSGRAVE, *supra* note 9, at 116 ("The better the rule in the absence of strategy . . . the greater tends to be the scope which it leaves for the use of strategy.").

²⁰ See *supra* note 13.

²¹ See *infra* text accompanying note 150.

²² See S. REP. No. 938, 94th Cong., 2d Sess., pt. 2, at 38-39 (1976) (exclusion for group legal services plans enacted to "increase the access to legal services for many taxpayers . . . especially . . . middle income taxpayers"; nondiscrimination rules to "minimize the possibility of abuse"); S. REP. No. 1263, 95th Cong., 2d Sess. 102 (1978) (nondiscrimination required in educational assistance plans to ensure program "available to a broad class of employees."); H.R. REP. No. 432, 98th Cong., 2d Sess. 1592 (1984)

nation rules have accomplished this end and the effect recent changes in the Code will have on this implicit design.

II EMPLOYEE FRINGE BENEFITS

A. The Genesis of Nondiscrimination Rules

As a general rule, all compensation is includable in the taxable income of the person who earns it, regardless of the medium of payment.²³ An employee who receives a \$300 air conditioner, for example, is supposed to pay the same amount of income tax as a similarly situated employee who receives \$300 cash instead. The reason for this rule is obvious; any other rule would encourage the development of a barter economy²⁴ at the cost of tax revenues,²⁵ economic efficiency,²⁶ and basic horizontal equity.²⁷

(nondiscrimination rule included because "it would be fundamentally unfair to provide tax-free treatment for economic benefits that are furnished only to highly paid executives"). Cf. *Tax Treatment of Employee Fringe Benefits: Written Comments and Hearings Before a Task Force of the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 32 (1978) (testimony of Donald Lubick, Asst. Sec'y of the Treasury for Tax Policy) ("policy to encourage the development of broadly based private pension plans has been carried out by the provisions which require . . . a broad standard of nondiscrimination") [hereinafter Lubick Testimony]. But see Fox & Schaffer, *Tax Policy as Social Policy: Cafeteria Plans, 1978-1985*, 12 J. HEALTH POL., POL'Y & L. 609, 630 (1987) (describing mixed motives of Treasury officials seeking enactment of nondiscrimination rules).

²³ See Treas. Reg. § 1.61-2(d)(1) (1988):

[I]f services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation. If services are paid for in exchange for other services, the fair market value of the services taken in payment must be included in income as compensation.

Id. See also *Commissioner v. Smith*, 324 U.S. 177, 181 (1945) (statutory predecessor of I.R.C. § 61(a) "is 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").

²⁴ If we lived in a country where cash salaries were taxable while other forms of salary were not, an employee in a 25% marginal tax rate bracket would prefer \$230 in untaxed "property" to \$300 in cash. Employers would be even more delighted to avoid \$70 in labor costs. One could expect, therefore that every employee would seek payment in property rather than cash. Ultimately, property transfers (barter) would drive out cash as a medium of exchange in the labor market. See M. GRAETZ, *FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES* 116-17 (2d ed. 1988).

²⁵ As more and more salaries came in nontaxable form, the tax base would diminish, and, absent an increase in tax rates, revenue collections would drop accordingly.

²⁶ Especially if employees are limited in the types of property they may choose tax free, employees may elect to receive wage-property packages very different from those they would choose in a tax free world. M. GRAETZ, *supra* note 24, at 117. Such changes in expenditure patterns can create not only what economists call a "deadweight loss," see W. KLEIN, B. BITTKER, & L. STONE, *supra* note 2, at 116-17; Clotfelter, *Equity, Efficiency, and the Tax Treatment of In-Kind Compensation*, 32 NAT'L TAX J. 51 (1979), but also they can actually result in inflation of the costs of the "oversubscribed" activity. *E.g.*, Feldstein, *The Welfare Loss of Excess Health Insurance*, 81 J. POL. ECON. 251, 252 (1973); Kosters &

As an administrative matter, however, the Internal Revenue Service has not required employees to include in income the value of air-conditioning and similar benefits consumed at their workplace.²⁸ Similarly, taxpayers need not include in income the amount of personal benefit derived from a large, well-appointed office.²⁹ Exclusion is the rule even in cases where the employees explicitly bargain away cash wages in exchange for improved working conditions. The traditional explanations for excluding such items from the tax base are that, because these items are provided primarily for business purposes, an employee's personal benefit is likely to be minor and the benefit will be difficult to value accurately.³⁰ In short, inclusion would require too much work for too little revenue gain.

As might be expected,³¹ employers and employees have sought to expand the category of expenditures that qualify for treatment as fringe benefits to the employee beyond those benefits consumed at the workplace. Such items benefit employees just like cash salary but have the dual tax advantages of not being income to the employee and being deductible to the employer.

The Internal Revenue Service, and eventually Congress,³²

Steuerle, *The Effect of Fringe Benefit Tax Policies on Labor and Consumer Markets*, 74 NTA-TIA 86, 90-91 (1981).

²⁷ Those employees and employers unable to work out a property transfer arrangement in lieu of cash salary would incur an unfair tax burden—especially if tax rates rose to ameliorate the revenue loss. See M. GRAETZ, *supra* note 24, at 117. See also H.R. REP. No. 432, 98th Cong., 1st Sess. 287 (1983), expressing concern that:

without any well-defined limits on the ability of employers to compensate their employees tax free by using a medium other than cash, new practices will emerge that could shrink the income tax base significantly, and further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash.

Id.

²⁸ Simon, *Fringe Benefits and Tax Reform: Historical Blunders and a Proposal for Structural Change*, 36 U. FLA. L. REV. 871, 876 (1984). Congress did not explicitly authorize this policy until 1984. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 531(a), 98 Stat. 494, 879 (codified as amended at I.R.C. § 132(d)) (excluding "working condition fringe benefits" from income).

²⁹ Simon, *supra* note 28, at 876.

³⁰ *Id.*; M. GRAETZ, *supra* note 24, at 137.

³¹ See *supra* note 24 (describing the financial benefits of avoiding employee-level income taxation of salary amounts).

³² As can be gleaned from the history of the various fringe benefit provisions contained *infra* notes 33-37, administrative acceptance of fringe benefit exclusions generally preceded explicit statutory authorization for such exclusions. Most of the statutory exclusions were enacted in the late 1970's and early 1980's. See, e.g., Tax Reform Act of 1976, Pub. L. No. 94-445, § 2134(a), 90 Stat. 1520, 1926 (codified as amended at I.R.C. § 120) (excluding the value of qualified group legal service plans from income); Energy Tax Act of 1978, Pub. L. No. 95-618, § 242(a), 92 Stat. 3174, 3193 (codified as amended at I.R.C. § 124) (excluding the value of employer-provided qualified transportation from income); Revenue Act of 1978, Pub. L. No. 95-600, § 164(a), 92 Stat. 2763, 2811 (codified as amended at I.R.C. § 127) (excluding the value of educational assistance programs from income); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 124(e)(1), 95

proved receptive to these efforts, allowing tax-free treatment of such disparate benefits as life insurance,³³ health and accident insurance,³⁴ dependent care,³⁵ educational assistance,³⁶ and free or discounted sales of the employer's product.³⁷ Although some of these items are like air-conditioned work places in that they can be partially or totally consumed on the business premises of the employer, many confer benefits on employees outside the workplace. More

Stat. 172, 198-99 (codified as amended at I.R.C. § 129) (excluding the value of dependent care assistance programs from income); Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 531-532, 98 Stat. 494, 877-87 (codified as amended at I.R.C. §§ 132, 133 and 117) (excluding the value of miscellaneous traditional employee fringe benefits from income).

³³ In 1920, the Solicitor of the Internal Revenue held that the value of employer-provided group-term life insurance was not income for purposes of the income tax laws. L.O. 1014, 2 C.B. 88 (1920). By the 1960's, this position was so noncontroversial that Treasury incorporated it into a regulation. Treas. Reg. § 1.61-2(d)(2)(1963). The following year, Congress codified a modified version of the rule as section 79 of the Code. Section 79 provided that employees could exclude from gross income the value of the first \$50,000 in coverage of employer-provided, group-term life insurance, but had to include the value of any excess at rates specified in the regulations. See Revenue Act of 1964, Pub. L. No. 88-272, § 204(a)(1), 78 Stat. 19, 36 (current version at I.R.C. § 79). As the regulation rates are generally set at close to the costs large employers face when obtaining insurance for their employees—thus reflecting substantial volume discounts—the resulting inclusion often understates the market value of the insurance provided. See T.D. 7924, 1984-1 C.B. 23, 23 (table uses 10.5% loading charge, 7 points lower than arithmetic mean of such charges on a policy by policy basis); *Insurance: IRS Proposes New Table to Determine Group-Term Life Insurance Costs*, 130 DAILY TAX REP. G-4 (July 6, 1983) (loading charges vary from 5% for large, experience-rated groups to 30% for small groups); cf. I.R.C. § 89(g)(3)(c)(ii) (value of excess benefits includable in employee's income due to discriminatory nature of life insurance plan is the greater of actual cost of excess coverage and cost of such coverage determined under section 79(c)).

³⁴ The Internal Revenue Service ruled in 1943 that employers could deduct and employees could exclude from gross income premiums paid by an employer for group medical care and hospitalization insurance. Special Ruling, 3 Fed. Tax Rep. (CCH) ¶ 6587 (1943). When Congress codified that rule at section 106 in 1954, it extended the exclusion to individual policies as well. S. REP. No. 1622, 83d Cong., 2d Sess. 186 (1955) ("the exclusion is applicable regardless of whether the employer's plan covers one employee or a group of employees").

³⁵ Congress first authorized the exclusion from employees' gross income of the value of certain dependent care assistance programs provided by an employer in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 124(e)(1), 95 Stat. 172, 198-99 (codified as amended at I.R.C. § 129).

³⁶ Congress enacted this exclusion as a temporary measure as part of the Revenue Act of 1978, Pub. L. No. 95-600, § 164(a), 92 Stat. 2763, 2811 (current version at I.R.C. § 127). Originally limited to taxable years beginning before January 1, 1983, Congress thrice extended its life, see Educational Assistance Programs, Pub. L. No. 98-611, § 1(a), 98 Stat. 3176, 3176 (1984); Tax Reform Act of 1986, Pub. L. No. 99-514, § 1162, 100 Stat. 2085, 2510; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 4001, 102 Stat. 3342, 3643; it is currently set to expire with taxable years beginning before January 1, 1988. I.R.C. § 127(d).

³⁷ Congress codified a preexisting informal administrative practice of ignoring these items for tax purposes when it enacted section 132 of the Code as part of the Deficit Reduction Act of 1984. See Shaller, *The New Fringe Benefit Legislation: A Codification of Historical Inequities*, 34 CATH. U.L. REV. 425, 427-29 (1985).

importantly, the cost of most of these fringe benefits could not be deducted as work related expenses by employees who purchased them directly.³⁸ Indeed, in some cases Congress abandoned any pretense of a link between the tax-free fringe benefits and the needs of the workplace and described their exclusion from income as tax subsidies for socially desirable expenditures.³⁹ These fringe benefits—excludable from an employee's income if provided by his employer but not deductible from the employee's income if he purchases them himself—are the focus of this section.⁴⁰

The employer's ability to distribute these benefits to employees on a tax-free basis is not unlimited. The Code conditions the favorable tax treatment of benefits provided to highly paid or high ranking employees on the employer's provision of similar benefits, on similar terms, to a number of lower paid and lower ranking employees.⁴¹ In short, employers who discriminate against lower paid and lower ranking employees by failing to provide them with a share of tax-free fringe benefits run the risk of forfeiting the tax-free treatment of benefits provided other employees.⁴²

As the discussion below explains, the rules for determining whether lower paid employees have been granted their "fair share" of benefits have evolved from a vague administrative requirement that employers provide benefits to a "group" of employees into an extraordinarily complex set of "nondiscrimination rules." The tale of how and why these rules developed as they did is an interesting example of how integration of the tax system and social legislation has greatly complicated the revenue raising process. It is recounted here, however, because one cannot understand how well the nondis-

³⁸ Taxpayers personally purchasing dependent care assistance obtain partial tax relief in the form of a limited credit, and those purchasing health insurance obtain a deduction. See I.R.C. § 21(c) (providing tax credit of between 20% and 30% on up to \$4800 of child care expenses); I.R.C. § 213(a) (allowing itemized deduction for expenses of obtaining health insurance to the extent such expenses, together with other medical costs incurred by taxpayer during the taxable year exceed 7.5% of taxpayer's adjusted gross income for the year); and I.R.C. § 162(m) (providing self-employed individuals with above-the-line deduction for 25% of costs of obtaining health insurance). However, for many taxpayers neither the credit nor the deduction is as valuable as a complete exclusion.

³⁹ *E.g.*, S. REP. NO. 830, 88th Cong., 2d Sess. 46 (1964) (\$70,000 life insurance exemption provided to encourage employers to provide life insurance); S. REP. NO. 938, *supra* note 22, at pt. 2, at 38-39 (exclusion for prepaid legal services provided to promote access of middle income taxpayers to legal services).

⁴⁰ Employer provided pensions involve independent issues which are beyond the scope of this Article.

⁴¹ See *infra* text and notes 52-145 (describing statutory nondiscrimination rules).

⁴² The consequences of discrimination vary according to the benefit being provided. Discriminatory provision of some benefits causes only highly paid or high ranking employees to lose the benefit of the exclusion, while all recipients must include in income the value of other types of benefits received pursuant to discriminatory plans.

crimination rules work to impose the condition of "multi-peaked" preferences necessary for the impossibility theorem to come into play⁴³ without grasping some of the details of the statutory scheme. Moreover, one can not appreciate the importance of (or the difficulties involved in changing) some of those details without understanding how they came to be adopted in the first instance.

1. *Administrative Antecedents of Nondiscrimination Rules*

Well before the advent of formal nondiscrimination rules, the fringe benefit exclusions contained a restriction which arguably had the same distributional effect: the requirement that benefits come in "group" form. For example, the first administrative ruling to confront the tax treatment of employer-provided life insurance held that the value of this insurance could be excluded from the recipient's income only if the insurance was issued under a group-term policy.⁴⁴ A later ruling clarified the earlier holding, stating that insurance provided pursuant to an individual term insurance policy did not qualify for favorable tax treatment.⁴⁵ This distinction was carried through into each regulatory and statutory enactment of the life insurance exclusion.⁴⁶

Although a group insurance policy need not cover both lower and higher paid employees in a given business, both Congress and the Treasury initially assumed this would usually be the case.⁴⁷ In-

⁴³ See *supra* note 13.

⁴⁴ L.O. 1014, 2 C.B. 88.

⁴⁵ Gen. Couns. Mem. 8432 (1930) (premiums on individual term insurance policy for corporate executive includable in his income); Gen. Couns. Mem. 16,069 (1936) (reaffirming that insurance must cover a group of employees to qualify for the exclusion).

⁴⁶ See Walker, *Group Life Insurance*, 23 N.Y.U. INST. ON FED. TAX'N 154-56 (1965) (recounting regulatory and statutory evolution of life insurance exclusion). The administrative ruling allowing employees to exclude the value of employer-provided health insurance from income similarly confined itself to group plans. See *supra* note 34. However, Congress eliminated this restriction when it codified the exclusion in 1954. *Id.* At the same time, Congress decided against including an explicit nondiscrimination rule in section 105 of the Code, which excluded amounts paid to employees as compensation for injuries and sickness under health and accident "plans" maintained by their employers. Such a provision was included in the version of the tax bill passed by the House, see H.R. 8300, 83d Cong., 2d Sess. § 105, 100 CONG. REC. 2957 (1954); however, the Senate deleted it, see S. REP. NO. 1622, *supra* note 34, at 16, and the House receded in conference. See CONF. REP. NO. 2543, 83d Cong., 2d Sess. 24-25 (1954). One commentator half-heartedly argues that the deletion occurred for technical reasons and that an implied nondiscriminatory requirement remained. See Note, *Taxation of Employee Accident and Health Plans Before and Under the 1954 Code*, 64 YALE L.J. 222, 234-35 & nn.78-79 (1954). For further discussion of the issues raised in the 1954 codification, see *id.*; Pyle, *Accident and Sickness Insurance Under Code Sections 104, 105, 106 and 213*, 34 TAXES 363, 365-73 (1956).

⁴⁷ Several commentators point out that there were no formal restrictions on discrimination in employer-provided life insurance plans at least until the enactment of section 79 in 1964. See Fasan, *Income Tax Treatment of Premiums Paid by an Employer on*

deed, when taxpayers and their insurers began deviating from this norm, various statutory and regulatory changes appeared in the life insurance provisions to ensure that coverage did not favor executives.⁴⁸ The courts enforced these regulatory restrictions, regularly finding that too great a discrepancy between the coverage afforded high and low income employees placed an insurance plan outside the definition of a "group" policy.⁴⁹

2. *Statutory Evolution*

The first explicit statutory nondiscrimination rule appeared in 1942 as a condition precedent to special tax treatment of certain pension plans and deferred compensation arrangements.⁵⁰ Although nondiscrimination rules became an increasingly important element of federal regulation of pension plans in the years that followed, Congress did not begin imposing statutory restrictions on

Group-Term Life Insurance Which Covers Only the Lives of Owner-Employees, 47 TAXES 496, 497-98 (1969); Guthnes, *Group Term Life Insurance, Income and Estate Tax Consequences of '64 Act and Regulations*, 103 TR. & EST. 1094, 1094 (1964). However, another commentator concludes that their absence is "misleading" because, at least initially, state insurance laws and insurance companies' underwriting requirements provided some protection against discrimination. See Walker, *supra* note 46, at 162 (citing requirement of distinguishing between group and individual policies, prohibition against individual selection, and low state limits on group policy benefits as guards against excessive discrimination in early years of exclusion). Further, in the health insurance context, many congressmen believed until quite recently that insurance considerations would force most employers to use nondiscriminatory group plans even in the absence of any congressional directive. See S. REP. NO. 1263, *supra* note 22, at 186 ("underwriting considerations generally preclude . . . abuses in insured [health] plans"). Despite evidence of past abuses, many continued to believe that underwriting requirements, as well as the fact that group insurance policies become cheaper as the size of the group increases, deterred discrimination. See STAFF OF JOINT COMM. ON TAX'N AND STAFF OF HOUSE COMM. ON WAYS AND MEANS, DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES 88 (Comm. Print 1982) ("[C]ost savings resulting from including a large number of individuals in an insured plan already tend to discourage discrimination.").

⁴⁸ When it enacted section 79, Congress capped the insurance exclusion at \$50,000 to prevent highly paid corporate executives from receiving "excessive" amounts of tax favored coverage. See S. REP. NO. 830, *supra* note 39, at 45. To prevent abuse by owner-employees, the 1966 regulations under this section provided, "[a] plan under which insurance is available only to employees who own stock in the employer corporation does not qualify as a plan or group insurance for purposes of section 79. . . .", Treas. Reg. § 1.79-1(b)(1)(iii)(b) (1967). More generally, the regulations required the insurance policy to "preclude individual selection." *Id.*

⁴⁹ See, e.g., *Towne v. Commissioner*, 78 T.C. 791 (1982) (holding a policy applicable to company president was not part of group-term plan because it allowed "individual selection" of coverage amount); *Braswell v. Commissioner*, 42 T.C.M. (CCH) 1053 (1981) (same); *Whipple Chrysler-Plymouth v. Commissioner*, 31 T.C.M. (CCH) 230, 233-34 (1972) (insurance policy applicable solely to owner of dealership not a group plan).

⁵⁰ Revenue Act of 1942, Pub. L. No. 77-753, § 162(a), 56 Stat. 798, 862 (1943). For a description of the history of this provision and the controversy surrounding its enactment, see Tarleau, *Development of Legislation on Pension Trusts*, 77 J. ACCT. 376, 379-81 (1944).

other fringe benefits until the late 1970's. At that time, Congress began enacting explicit statutory sanctions for a host of new tax-free fringe benefits.⁵¹

Congress first provided a fringe benefits nondiscrimination rule in the enabling legislation for group legal services.⁵² This rule, contained in section 120(c) of the Code,⁵³ provided:

(1) **DISCRIMINATION**—The contributions or benefits provided under the plan shall not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated.

(2) **ELIGIBILITY**—The plan shall benefit employees who qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are described in paragraph (1). For purposes of this paragraph, there shall be excluded from consideration employees not included in the plan who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that group legal services plan benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.

(3) **CONTRIBUTION LIMITATION**—Not more than 25 percent of the amounts contributed under the plan during the year may be provided for the class of individuals who are shareholders or owners (or their spouses or dependents), each of whom (on any day of the year) owns more than 5 percent of the stock or of the capital or profits interest in the employer.⁵⁴

Compliance with these rules was (and continues to be) a “requirement” for “qualified group legal services plans” and the exclusion from recipients’ taxable income provided in section 120(a) applied only to contributions made to, and benefits received from, a “qualified group legal services plan.” The penalty for failing to comply with the nondiscrimination requirements was the loss of that exclusion for recipients of benefits under the plan; all beneficiaries of a discriminatory plan had to include the entire value of their benefits in their gross income.⁵⁵

Congress included similar nondiscrimination rules in subse-

⁵¹ See *supra* note 32.

⁵² Tax Reform Act of 1976, Pub. L. No. 94-445, § 2134(a), 90 Stat. 1520, 1926 (codified as amended at I.R.C. § 120(c)).

⁵³ Unless specifically identified otherwise, all references to “sections” contained herein are to sections of the Internal Revenue Code.

⁵⁴ I.R.C. § 120(c) (1985).

⁵⁵ See I.R.C. §§ 120(a)-(b) (1977). Although the content of the nondiscrimination rule has changed slightly since its original enactment, the penalty for violating the rule remains the same.

quent fringe benefit provisions.⁵⁶ Congress also added comparable restrictions to preexisting fringe benefit exclusions such as health benefits⁵⁷ and life insurance.⁵⁸ The coverage and contribution standards applicable to qualified pension plans⁵⁹ were the model for each of these rules.⁶⁰ Nevertheless, considerable differences existed among the various fringe benefit nondiscrimination rules.⁶¹ The Tax Reform Act of 1986 ("1986 Tax Act")⁶² reduced or eliminated some of these differences, but even after these changes become fully effective,⁶³ nondiscrimination rules will be far from uniform.

Like the pension plan rules, most of the fringe benefit nondiscrimination rules evaluate fringe benefits in terms of the presence or absence of discrimination in favor of a "suspect class" of "officers, owners and highly compensated employees."⁶⁴ The rules look to

⁵⁶ See Energy Tax Act of 1978, Pub. L. No. 95-618, § 242(a), 92 Stat. 3174, 3193 (codified as amended at I.R.C. § 124(c)); Revenue Act of 1978, Pub. L. No. 95-600, § 164(a), 92 Stat. 2763, 2811 (codified as amended at I.R.C. § 127(b)); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 124(e)(1), 95 Stat. 172, 198-99 (codified as amended at I.R.C. § 129(d)); Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 531(a), 532, 98 Stat. 494, 877, 887 (codified as amended at I.R.C. §§ 132(e)(2), (h)(1) & 117 (d)(3)).

⁵⁷ See Comprehensive Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 10001(b), 100 Stat. 82, 223 (codified as amended at I.R.C. § 106(b)) (imposing nondiscrimination rules on insured health plans); Revenue Act of 1978, Pub. L. No. 95-600, § 366(a), 92 Stat. 2763, 2855 (codified as amended at I.R.C. § 105(h)) (imposing nondiscrimination rule on employer-funded, uninsured medical reimbursement plans).

⁵⁸ See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 244(a), 96 Stat. 324, 523-24 (codified as amended at I.R.C. § 79(d)).

⁵⁹ These standards, as amended, are set forth in I.R.C. §§ 401(a)(3)-(5) and 410(b).

⁶⁰ Wiedenbeck, *Nondiscrimination in Employee Benefits: False Starts and Future Trends*, 52 TENN. L. REV. 167, 173 (1985).

⁶¹ *Id.*; compare I.R.C. § 127(b)(2)-(3) with I.R.C. § 105(h)(3)-(5). Both provisions were enacted as part of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.

⁶² See Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1114(b), 1151, 100 Stat. 2085, 2450, 2494. One aim of the 1986 legislation was the establishment of greater uniformity between nondiscrimination rules. S. REP. NO. 313, 99th Cong., 2d Sess. 651 (1986). Especially because no one remembered the reasons for many of the differences among similar statutory phrases and rules, retaining them seemed an unwarranted burden on affected taxpayers. For a discussion of the changes effected by this Act, see *infra* text accompanying notes 79-97, 124-45.

⁶³ A number of the changes mandated by the Tax Reform Act of 1986 have delayed effective dates. See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, § 1151(k), 100 Stat. 2085, 2508 (providing that amendments made by that section of the Act shall apply to years beginning after the later of December 31, 1987 or the earlier of three months after the promulgation of regulations necessary to carry out the new section 89 or December 31, 1988). The Technical and Miscellaneous Revenue Act of 1988 postpones implementation of some of section 89's valuation rules until "testing years beginning before the later of January 1, 1991, or the date one year after the Secretary of the Treasury . . . first issues such valuation rules as are necessary"; and provides simplified rules to use in the interim. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3021(c), 102 Stat. 3342, 3633-34.

⁶⁴ I.R.C. § 132(h)(1). The linguistic contours of the suspect group, as well as the technical definitions of the terms used, varied from statute to statute. Compare I.R.C.

discrimination in terms of eligibility⁶⁵ or participation⁶⁶ and amounts of in-kind benefits distributed under the plan. Plans⁶⁷ must be nondiscriminatory in terms of all three elements in order

§ 105(h)(5) (1985) (forbidding discrimination in favor of "highly compensated individuals," who were one of the five highest paid officers, greater than 10% shareholders, or the highest paid 25% of all employees) with I.R.C. § 79(d)(6) (forbidding discrimination in favor of "key employees," defined as officers receiving more than \$45,000 compensation, one of ten employees receiving more than \$30,000 compensation and owning the largest interests in the employer, a 5% owner, or a 1% owner earning more than \$150,000) and I.R.C. § 125(e)(1) (defining "highly compensated participant" as an officer, a more than 5% shareholder, highly compensated, or a spouse or dependent of one of the above-listed individuals). See generally Wiedenbeck, *supra* note 60, at 184-85. The Tax Reform Act of 1986 replaced most of the phrases used in the fringe benefit statutes with a single definition designed specifically to eliminate such variations. STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 792 (1987) ("highly compensated employees as defined in I.R.C. § 414(q)") [hereinafter 1986 GENERAL EXPLANATION]. Section 79(d), however, continues to use the "key employee" language. I.R.C. § 79(d).

⁶⁵ An "eligible employee" is one entitled to participate in a fringe benefit program or who would be so entitled if he or she fulfilled contingencies within his or her exclusive control. Wiedenbeck, *supra* note 60, at 174-75. For example, an employee who would receive employer-provided health insurance if he agreed to contribute \$50 per month towards the cost of the plan would be considered eligible to participate in such plan. On the other hand, contingencies that are technically within an employee's control but require a considerable period of time to satisfy may render an employee "ineligible." In regulations explaining "eligibility" in the context of educational assistance programs, Treasury provides:

[I]f an employer's plan provides that all employees are eligible for educational assistance, yet limits that assistance to courses of study leading to post-graduate degrees in fields relating to the employer's business, then only those employees able to pursue such a course of study are considered actually eligible for educational assistance under the program.

Treas. Reg. § 1.127-2(e)(1)(1986).

⁶⁶ An employee "participates" in a fringe benefit plan if he may receive a specific item of in-kind compensation or reimbursement when the need arises. Wiedenbeck, *supra* note 60, at 195. All "eligible employees" may be "participants" in a plan; however, if the plan requires eligible employees to satisfy a condition in order to become eligible to receive benefits, only those employees satisfying such conditions will be deemed "participants." Thus, if a firm provides an on-premise day care center for the preschool children of any employee, all employees are participants, even those without children. But if the facility is restricted to children of employees who have paid \$500 per year in advance, although all employees are "eligible employees," only those who contribute \$500 are "participants." *Id.*

⁶⁷ The relevant statutes inevitably provide for the exclusion of benefits supplied pursuant to a "plan" or "program" maintained by the employer. See, e.g., I.R.C. §§ 105(h), 120(a). Although early commentators speculated that the requirement of a "plan" might provide opportunities for Treasury and judicial regulation of such benefits, see, e.g. Note, *supra* note 46, at 231-36, nothing much came from this language until Congress enacted I.R.C. § 89(k) in 1986. This statute prescribes, for the first time, "certain basic standards" that a fringe benefit plan must satisfy in order to qualify for a statutory exclusion. The plan must be in writing, employees' rights under it must be legally enforceable, employees must have reasonable notification of any benefits available to them, the plan must operate for the exclusive benefit of the employees, and the employer must have established the plan with the intent of continuing it indefinitely. 1986 GENERAL EXPLANATION, *supra* note 64, at 811-12. Cf. Bogene, Inc. v. Commissioner, 27 T.C.M. (CCH) 730, 732-33 (1968) (holding under regulations then in force

for all benefits to be assured fully nontaxable treatment. If a plan is found to be discriminatory, some or all of the benefits become includable in recipients' income, and may therefore be less rather than more desirable than cash salary equal to the cost of such benefits.⁶⁸

a. *Eligibility and Participation Tests.*

First, plans must ensure that a sufficiently broad cross-section of employees actually participate or are eligible to participate. The breadth of participation required varies according to the type of benefit and the employer involved. Prior to the 1986 Tax Act, the most common "eligibility" provision required that "the plan shall benefit employees who qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are"⁶⁹ members of the relevant suspect group.⁷⁰ In the absence of other, more explicit statutory standards,⁷¹ conformity with this standard required that the proportion of suspect group employees participating in a plan⁷² approximate

that a plan need not be in writing, employee's rights under it need not be enforceable, and notice or knowledge of plan only needs to be "reasonably available" to employees).

⁶⁸ The tax consequences of failing to meet discrimination tests vary with the type of benefit involved. In some cases, all benefits distributed under the plan become taxable to all recipients. See I.R.C. § 120(b)(2) (group legal services); I.R.C. § 124(c) (employer-provided transportation); I.R.C. § 127(b) (educational assistance); I.R.C. § 129(d)(1) (dependent care assistance). In other cases, such benefits become includable only for highly compensated individuals. See I.R.C. § 79(d)(1) (group-term life insurance); I.R.C. § 125(a)(2) (cafeteria plans); I.R.C. § 132(h)(1) (no-additional-cost services and qualified employee discounts). New section 89, following the pattern established in section 105(h) for uninsured medical reimbursement plans, provides that only the "excess benefit" received by highly compensated employees will be included in income. I.R.C. § 89(a)(1) (applicable after the effective date, see *supra* note 63, to health plans, group life insurance plans and, where elected by the employer, qualified group legal services plans, educational assistance programs, and dependent care programs).

⁶⁹ E.g., I.R.C. §§ 120(c)(2), 127(b)(2), 129(d)(3) (1985). See Wiedenbeck, *supra* note 60, at 194.

⁷⁰ See *supra* note 64.

⁷¹ Several fringe benefit statutes included more numerical coverage tests as an alternative to this general discretionary test. See, e.g., I.R.C. §§ 79(d)(3)(A), 105(h)(3)(A) (1985).

⁷² Although one could logically contend that no employee benefits from a fringe benefit plan until he or she actually receives in-kind distributions, it is clear from a combination of statutory language, regulations, and legislative explanations that employees are deemed to benefit when the plan makes benefits available to them. See *supra* note 66. For example, section 79(d)(3)(A) includes a mathematical test for group-term life insurance that can only be satisfied if 70% of all employees "benefit" from the plan. See also I.R.C. § 105(h)(3)(A)(i) (self-insured medical plan must "benefit" 70% or more of all employees or 80% of eligible employees if 70% are eligible). As one commentator points out, using such a liberal definition of "benefit" makes more sense in the context of "insurance type benefits," where protection against an unlikely but calamitous event is valuable in itself, than in the context of plans which protect against "the financial consequences of events that are highly predictable" (e.g., child care). Wiedenbeck, *supra* note 60, at 194-95. Nonetheless, except for the special rules applicable under the newly

the proportion of the employer's other employees⁷³ participating.⁷⁴ For example, a plan covering a mere 20% of the employer's total work force (omitting excludable employees), where participants included only 20% of the highly compensated employees would be nondiscriminatory. A plan covering 20% of the work force where participants included all highly compensated employees and only about 2% of the other employees, however, would be discriminatory.⁷⁵

Congress included bright line numerical tests as alternatives to

enacted section 89, *see infra* text accompanying notes 134-38, all the available evidence points to the use of this liberal definition of "benefits" in the latter context as well. *See, e.g.,* Treas. Reg. § 1.127-2(e)(1)(1986) ("... the classification of employees to be considered benefited [by an educational assistance program] will consist of that group of employees who are actually eligible for educational assistance under the program . . ."); STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 55 (Comm. Print 1981) (to meet nondiscriminatory eligibility requirement, dependent care assistance program "must be available to a broad class of employees rather than to a particular individual").

⁷³ The "other employees" group need not include all of the employer's nonhighly compensated employees. Prior to the 1986 Tax Act, the list of excludable employees differed from benefit, variously including, for example, part-time and seasonal employees, I.R.C. §§ 79(d)(3)(B)(ii), 105(h)(3)(B)(iii) (1985); employees covered by a collective bargaining agreement where evidence existed that the fringe benefit was the subject of good faith bargaining, I.R.C. §§ 79(d)(3)(B)(iii), 105(h)(3)(B)(iv), 120(c)(2), 127(b)(2), 129(d)(3) (1985); and employees of less than three years duration, I.R.C. §§ 79(d)(3)(B)(i), 105(h)(3)(B)(i), 125(g)(3)(B) (1985). Sometimes this group contained more employees than the phrase suggested on its face; the term "employer" often included not only the particular employment unit involved, but all trades or businesses controlled by the same individuals or entities as the subject unit. I.R.C. §§ 125(g)(4), 105(h)(8), 79(d)(7); *see* Wiedenbeck, *supra* note 60, at 186 (discussing background of expansive rule). As part of the 1986 Tax Act, Congress enacted uniform definitions of "excluded employees" and "employers," standardizing the comparison group for all fringe benefit plans, *see* 1986 GENERAL EXPLANATION, *supra* note 64, at 782, just as it did for the suspect group, *see supra* note 64. The new list of excludable employees includes employees with less than one year of service (six months in the case of "core" health benefits), employees who normally work less than 17.5 hours per week, employees who normally work less than six months a year, employees under age 21, employees covered by a collective bargaining agreement where the type of benefits provided by the plan was the subject of good faith bargaining, and nonresident aliens receiving no United States source income. I.R.C. § 89(h)(1). Once a plan covers any employee of a type excludable under the general rule, however, the exclusion for that type of employee ends. I.R.C. § 89(h)(2)-(5). The statutory exclusions covering fringe benefits outside section 89's scope now incorporate by reference this definition of "excludable employee." *See, e.g.,* I.R.C. §§ 132(h)(1), 129(d)(3), 127(b)(2), 125(b)(3).

⁷⁴ Regulations applicable to other types of fringe benefits incorporated this test by reference. *See, e.g.,* Treas. Reg. §§ 1.132-8T(c)(1), 1.127-2(e)(1), 1.105-11(c)(2)(ii) (1986). The test initially appeared in regulations explaining the import of virtually identical language in the qualified pension plan rules, *see* I.R.C. § 410(b)(1)(B) (1986); Treas. Reg. § 1.410(b)-1(d)(2) (promulgated in T.D. 7508, 1977-2 C.B. 124, amended by T.D. 7735, 1981-1 C.B. 217).

⁷⁵ The regulation allows a "reasonable difference" between the coverage of the suspect and comparison groups. Treas. Reg. § 1.410(b)-1(d)(2) (1986). The absence of standards or guidelines for determining a "reasonable difference" has generated unfavorable comment, *see* Wiedenbeck, *supra* note 60, at 194, and was proffered by Congress

the more vaguely worded nondiscriminatory classification (really, nondiscriminatory participation) standard in the statutes covering life insurance and self-insured medical reimbursement plans.⁷⁶ The self-insured medical expense reimbursement test requires that either the plan cover 70% of all employees, or that a plan for which 70% of the work force is eligible cover 80% of eligible employees.⁷⁷ The group-term life insurance rule requires either 70% participation or that 85% of the insured employees not be "key employees."⁷⁸

The 1986 Tax Act includes a new tripartite nondiscrimination requirement.⁷⁹ Beginning in 1988 and 1989⁸⁰ the new test will be imposed on all employer-provided health, accident, and group-term life insurance plans, as well as such group legal services, educational assistance, and dependent care assistance programs as an employer elects.⁸¹ Congress relied almost exclusively on numerical standards when formulating the new test because it preferred the certainty numerical formulas provided.⁸² Fringe benefit plans subject to the new test must satisfy each of the three requirements described below.

as one reason for adopting more numerically precise tests, *see infra* text accompanying notes 83-97. *See* 1986 GENERAL EXPLANATION, *supra* note 64, at 781.

⁷⁶ *See* Wiedenbeck, *supra* note 60, at 191 & nn.80-81.

⁷⁷ Taxpayers may disregard excludable employees when calculating each of these percentages. I.R.C. § 105(h)(3). For a critique of this standard, *see* Wiedenbeck, *supra* note 60, at 189-90.

⁷⁸ I.R.C. § 79(d)(3)(A). For a definition of "key employee," *see supra* note 64.

⁷⁹ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1151(a), 100 Stat. 2085, 2494-2502 (codified as amended at I.R.C. § 89).

⁸⁰ *See supra* note 63.

⁸¹ Section 89 includes certain amounts provided under "discriminatory employee benefit plan[s]" in the gross income of highly compensated employees. I.R.C. § 89(a)(1). "Discriminatory employee benefit plans" are defined as any "statutory employee benefit plans" that fail to meet the requirements of section 89(d) and (e). I.R.C. § 89(c). "Statutory employee benefit plan" is a defined term encompassing (1) an accident or health plan within the meaning of section 105(e), (2) any plan of an employer providing group-term life insurance within the meaning of section 79, and (3) a qualified group legal services plan, an educational assistance program, or a dependent care assistance program elected by the employer. I.R.C. § 89(i). Congress explained its decision to treat educational assistance and group legal plans as statutory plans only on an elective basis by pointing out that their statutory basis will disappear entirely before section 89's nondiscrimination rules become effective and expressed a desire that they be covered by the new rules if such statutory authorization is extended beyond that date. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 508 (1986). Congress gave no reason for its treatment of dependent care assistance plans—nor for its failure to allow other types of benefit plans to be treated as "statutory" even on an elective basis. *See id.*

⁸² *See* H.R. REP. NO. 426, 99th Cong., 1st Sess. 769 (1985) (citing as "reasons for change" of nondiscrimination rules that the old rules were "inconsistent and fail[ed] to establish clear and administerable standards"); S. REP. NO. 313, *supra* note 62, at 650 (citing as "reasons for change" of nondiscrimination rules that "little specific guidance is provided as to whether a particular pattern of coverage discriminates in favor of prohibited group members").

The first prong of this tripartite eligibility test is that 90% of nonhighly compensated employees⁸³ be eligible to participate in the same plan, or a plan of the same type,⁸⁴ on terms that grant them an employer-provided benefit⁸⁵ of at least half the value of that available to any highly compensated employee.⁸⁶ For example, if the most valuable benefit available to a highly compensated employee under an employer's plan (or combination of plans) is \$100, 90% of the employer's nonhighly compensated workers must be eligible to participate in a plan (or plans) providing \$50 worth of the same benefits. The test looks to the eligibility of employees to participate rather than to actual participation rates. Thus, if the president of a company is eligible to participate in health insurance plans which together would provide \$100 of employer-provided health insurance coverage, 90% of the workers must be eligible to participate in plans providing \$50 of coverage—even if the president decides to participate in the plans only up to a value of \$70.⁸⁷ Amounts of available salary reduction⁸⁸ are generally ignored for purposes of this test.⁸⁹

⁸³ The employer may exclude employees of the types listed in section 89(h), *see supra* note 73, when determining the number of nonhighly compensated workers.

⁸⁴ Plans which provide benefits excludable under the same section of the Code are "of the same type." I.R.C. § 89(i)(3); 1986 GENERAL EXPLANATION, *supra* note 64, at 783.

⁸⁵ The statute values an "employer-provided benefit" according to "the value of the coverage" in the case of group life and health insurance plans, I.R.C. § 89(g)(3)(A)(i), and "the value of the benefits" in the case of other types of plans. I.R.C. § 89(g)(3)(A)(ii). Presumably, this means that if a health insurance plan offering reimbursement of up to \$250,000 in medical expenses costs \$500 per year to provide, an employee who would receive such coverage from her employer upon payment of a \$10 fee has \$490 in employer-provided benefits available to her under the statute; whereas an employee eligible to participate in a group legal services program under which she could receive up to \$1000 of legal services has \$1000 of employer-provided benefits available to her according to the statute. Yet the employer's *ex ante* cost of providing that benefit to her would be far less than \$1000 since most participants in the plan would not make use of the full \$1000 of available legal services during the year (any more than most of those covered under the health insurance plan would utilize all \$250,000 of available health insurance benefits). For further discussion of the meaning of "employer-provided benefit," *see infra* text accompanying notes 134-38.

⁸⁶ I.R.C. § 89(d)(1)(A).

⁸⁷ As the president might do if contributions to the plan were a condition of receiving the additional \$30 benefit.

⁸⁸ Elective salary reductions may fund certain types of benefits.

⁸⁹ I.R.C. § 89(g)(3)(D)(i). This almost has to be because, theoretically, employees might elect to forgo their entire salaries in return for additional fringe benefits. Counting available salary reduction amounts would thus cause any organization in which the highest paid employee makes more than twice what the lowest paid employee earns to fail the nondiscrimination test merely by offering a salary reduction option. Possibilities for abuse of this exclusion led Congress, however, to enact two safeguards. First, the second level utilization test includes salary reduction amounts. *See infra* text accompanying notes 124-45 (discussing second level tests). Further, Congress provided that in likely abuse situations, salary reduction amounts could be included even for purposes of

In addition to meeting this "90/50 test," section 89 requires that at least 50% of the employees eligible to participate in any particular plan be nonhighly compensated employees.⁹⁰ This second prong, unlike the 90/50 test, applies to each plan.⁹¹ An employer cannot, therefore, remedy one plan's failure to allow coverage of the requisite number of rank and file employees by surpassing the 50% rank and file standard under another plan. Because this test would make it impossible for employers with large percentages of highly compensated employees to offer nondiscriminatory fringe benefit plans—even if equal coverage were available to all employees—Congress enacted an alternative test for such employers.⁹² This alternative is essentially the numerical equivalent of the traditional nondiscriminatory classification test.⁹³ It requires that the percentage of nonhighly compensated employees eligible to participate in a plan equal or exceed the percentage of highly compensated eligibles.⁹⁴ Uniform eligibility would satisfy this formulation: whether the employer's work force consists of 70% or 7% highly compensated employees 100% of each group would be eligible to participate, resulting in equal percentages for each group. Covering 20% of both the highly compensated and nonhighly compensated employees would also satisfy this formulation. Unlike the generally worded nondiscriminatory classification test, this new standard does not allow the coverage of highly compensated employees to exceed that of nonhighly compensated workers by a "reasonable difference." The bright line "equal or exceeds" standard penalizes *any* deviation in coverage in favor of the suspect group.

The third and final prong of the new eligibility test disqualifies any plan with provisions relating to eligibility which discriminate in favor of highly compensated employees.⁹⁵ The exact scope of this

the 90/50 test. I.R.C. § 89(g)(3)(D)(ii)-(iii) (added by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3021(a), 102 Stat. 3342, 3625-31). Even without considering salary reduction amounts, determining the amount of benefits available to an employee may be very difficult—particularly when the employee's choice is among alternatives rather than cumulative.

⁹⁰ I.R.C. § 89(d)(1)(B).

⁹¹ To meet this requirement, employers may aggregate "comparable health plans," (health plans under which the smallest employer-provided benefit available to any participant is at least 95% of the largest employer-provided benefit available to any participant in either plan, *see* I.R.C. § 89(g)(1)(B), or, if both plans are available to the same group of employees on the same terms, the cost to the employee of participating in either does not vary by more than \$100 annually, *see* I.R.C. § 89(g)(1)(E)). A somewhat broader definition of comparability is used for purposes of the benefits tests contained in section 89(f). *See* I.R.C. § 89(g)(1)(A)-(D).

⁹² *See* 1986 GENERAL EXPLANATION, *supra* note 64, at 783.

⁹³ This is the eligibility test described *supra* text accompanying notes 69-75.

⁹⁴ I.R.C. § 89(d)(2).

⁹⁵ I.R.C. § 89(d)(1)(C).

requirement is far from clear. The *Conference Report* explains that the test is not intended to disqualify arrangements where the discrimination is "quantifiable," such as where an employer maintains one health plan for its salaried employees and another, of lesser value, for its hourly employees.⁹⁶ The *Conference Report* goes on to state, however, that if a plan is designed to suit the highly individualized needs of highly compensated employees, by providing unusual coverage for a rare condition to which only the owner of the employer is subject, such coverage may fail the third eligibility requirement even if the coverage theoretically extends to all employees.⁹⁷

b. *Benefits Tests.*

Merely providing nonhighly compensated employees with the opportunity to participate in a plan does not guarantee that they will actually participate—let alone receive benefits equivalent to those of highly paid employees. Nondiscriminatory eligibility requirements can be meaningless if conditions on participation discourage eligible rank and file employees from participating in the plan,⁹⁸ limit benefits offered to rank and file employees to a fraction of those offered

⁹⁶ H.R. CONF. REP. NO. 841, *supra* note 81, at pt. 2 at 510.

⁹⁷ *Id.* Although the accompanying Congressional reports do not explain the distinction beyond providing the example cited above, Congress apparently wanted to isolate differences in the provision of separable benefits rather than distinctions that permeate an entire plan (whatever those might be). This follows from Congress's defining "each option or different benefit offered under a statutory employee benefit plan . . . as a separate plan." H.R. CONF. REP. NO. 841, *supra* note 81, at pt. 2, at 529. That would leave employers significant opportunities to avoid unfavorable tax treatment by camouflaging the special coverage. Inasmuch as the Conference Committee has made clear that taxpayers may structure options so as to pass the nondiscrimination test (even though the same options structured differently would not), *id.*, at pt. 2, at 530, the Service may have difficulty in attacking such uses. Interestingly, the 1986 GENERAL EXPLANATION suggests this prong of the eligibility test is a secondary check on the Secretary's valuation tables, stating:

[a]nother example of a failure to satisfy the third eligibility test occurs if, under the facts and circumstances, the employer is satisfying the other nondiscrimination tests by providing or making available to nonhighly compensated employees benefits that clearly have less value than that ascribed to them under the Secretary's valuation tables. . . .

1986 GENERAL EXPLANATION, *supra* note 64, at 784. Although this description may be no more than a slight generalization of the Conference Committee's example (i.e., where the coverage has a high value for those with a particular disease and none at all for those without it), it may overwhelm the benefits test, discussed *infra* text accompanying notes 124-45.

⁹⁸ This problem arises, for example, if eligible employees need either to contribute to the plan or to incur some other liability to become a "participant" in the plan. See Wiedenbeck, *supra* note 60, at 195-96. Some "eligibility" requirements finesse this problem by testing participation rather than eligibility. See, e.g., *supra* text accompanying notes 70-75. Depending on how broadly section 89(d)(1)(C) is interpreted, its eligibility test may look only at eligibility, disregarding participation.

to highly compensated employees,⁹⁹ or provide benefits only upper income employees are likely to want or need.¹⁰⁰ For this reason, many nondiscrimination rules contain a second level of protection for lower paid employees: they require distribution of benefits in a nondiscriminatory fashion. Like the eligibility or coverage tests, these "benefits" tests come in a variety of forms.

Several statutes merely provide that any benefits available to highly compensated employees must be available to all participants.¹⁰¹ Sometimes they require that benefits be available on the same terms.¹⁰² This requirement, like some of the more elaborate coverage requirements, prevents *de jure* discrimination against lower level employees. It provides no impediment, however, to *de facto* discrimination arising from differences in the utilization rates of upper and highly and nonhighly paid employees (reflecting differing tastes and/or needs).¹⁰³ For example, an employer with a sickly executive and two, twenty-five year old file clerks could meet the literal demands of this requirement by providing each of its employees with a health insurance policy covering \$250,000 of medical expenses. The executive would reap a much larger economic benefit from the coverage than the nonhighly compensated file clerks.¹⁰⁴ Apparently, an employer could even run a study to decide which benefits were most desired by its executives, and then provide those benefits to the entire work force with the expectation (if not hope) that most of the rank and file would never take advantage of the benefits.¹⁰⁵

The most common form of benefits testing, the concentration

⁹⁹ Again, some of the "eligibility" requirements take care of this problem. *E.g.*, I.R.C. § 89(d)(1)(A)(ii) (requiring lower paid employees be eligible for benefits worth at least 50% of highest benefit available to highly compensated employees). Many, however, only require provision of *some* benefit to a nondiscriminatory set of employees. *E.g.*, I.R.C. §§ 79(d)(3)(A), 105(h)(3)(A), 129(d)(3).

¹⁰⁰ The most extreme forms of this abuse in "statutory employee benefit plan[s]" may be curtailed by operation of section 89(d)(1)(C). *See supra* text accompanying notes 95-97. Even when it takes effect, however, section 89 will only apply to certain types of plans. *See supra* text accompanying note 81. None of the older eligibility rules provides even the minimal protection of section 89(d)(1)(C). *See supra* note 72; *see also* Wiedenbeck, *supra* note 60, at 194-199 (arguing that coverage requirements are insufficient safeguards against discriminatory plan utilization).

¹⁰¹ *See* I.R.C. §§ 79(d)(4), 105(h)(4). In addition, section 79 has a nonegalitarian definition of the same benefits. An employer cannot fail the nondiscriminatory benefits test as long as it makes insurance coverage equal to the same multiple of salary available to each employee. I.R.C. § 79(d)(5).

¹⁰² *See* I.R.C. §§ 117(d)(3), 132(e)(2), 132(h)(1).

¹⁰³ Unless, of course, it is accompanied by another limitation which has this effect. *See infra* text accompanying notes 106-12.

¹⁰⁴ This would probably be the case regardless of whether one assesses the value of the benefit in terms of the cost of coverage provided or actual reimbursements.

¹⁰⁵ Wiedenbeck, *supra* note 60, at 222.

test, provides some protection against this type of *de facto* discrimination. For example, section 120(c)(3)¹⁰⁶ limits distributions to certain owner-employees¹⁰⁷ under a plan to a specified percentage of the total payments made under the plan.¹⁰⁸ Unlike the coverage tests, this test looks at the amounts actually received by (or paid out on behalf of) each participant under the plan and not the amount that may be received or the cost of coverage provided by the plan.¹⁰⁹ Of course, the impact of these limitations differs considerably depending on the size and composition of the affected work force,¹¹⁰ the definition of the suspect group,¹¹¹ and the percentage limitation.¹¹²

Both the concentration and the equal availability tests may be accompanied by a general requirement that “[t]he contributions or

¹⁰⁶ Quoted in full *supra* text accompanying note 54.

¹⁰⁷ Often, disbursements to highly salaried employees are ignored and the limitations fall only on disbursements to 5% owners or some other “super-suspect” group. See *infra* note 108 (detailing statutes).

¹⁰⁸ See, e.g., I.R.C. § 120(c)(3) (limiting contributions made on behalf of 5% owners or their spouses and dependents to 25% of total contributions); I.R.C. § 125(b)(2) (key employees must not receive more than 25% of the aggregate qualified benefits distributed pursuant to plan); I.R.C. § 127(b)(3) (no more than 5% of amount paid by employer for educational assistance may be provided to 5% owners or their spouses or dependents); I.R.C. § 129(d)(4) (amounts incurred by employer for dependent care assistance on behalf of 5% owners limited to 25 percent of aggregate expenditures).

¹⁰⁹ The language of most of the statutes makes this result crystal clear and the regulations proposed under the only statute with somewhat ambiguous language, section 120(c), mandate the same interpretation. See Prop. Treas. Reg. § 1.120-2(f)(3)(i)-(ii), 45 Fed. Reg. 28,360 (1980) which stated:

no legal service may be provided to a member of the limitation class if to provide the service would cause the fair market value of legal services provided to date during the plan year to members of the limitation class to exceed 25% of the fair market value of the legal services provided under the plan to date. . . .

Id. The language continued, “The extent to which members of the limitation class, as a class, utilize plan benefits shall be taken into account in determining the percentage of amounts contributed by the employer that is considered contributed on behalf of the limitation class. . . .” *Id.* at § 1.120-2(f)(5)(i).

¹¹⁰ The higher the percentage of highly compensated employees or 5% owner-employees in the employer’s work force, the more these restrictions bite. For example, if only 1% of the work force consists of owner-employees, each may receive 25 times the dependent care assistance provided rank and file employees without running afoul of the applicable limitation, while if 50% of the employees are also owners, each can receive (on average) only half the assistance provided the other employees if the plan is to meet the statutory requirement. Small businesses, which are more likely to have a substantial percentage of owner-employees, are thus more adversely affected by such requirements than large businesses. See Hall, *Operation of Group Legal Services Plan Not Clear: Additional Guidelines Needed*, 46 J. TAX. 108, 109 (1977).

¹¹¹ Five percent owners are likely to be a smaller percentage of the work force than “highly compensated” employees—particularly because the statutory definition of the latter generally includes the former. See *supra* note 64.

¹¹² The 25% limitation found in most of the relevant statutes is considerably more generous than the 5% cap in section 127(b)(3).

benefits provided under the plan shall not discriminate" in favor of highly placed or highly paid employees.¹¹³ This language, drawn directly from the pension plan nondiscrimination rules,¹¹⁴ is often meaningless in the fringe benefit context. Under most such plans, employees do not have individual accounts to which the employer makes contributions.¹¹⁵ Moreover the amount of benefits "provided" could be measured by the value of those *made available* to participants, or by those *actually received* by each individual.

In the Treasury's sole attempt to explain the operation of this nondiscriminatory benefits rule in the context of the provision of legal services,¹¹⁶ it states that differential utilization rates may be evidence of discrimination:

Not only must a plan not discriminate on its face in employer contributions or plan benefits in favor of employees who are officers, shareholders, self-employed or highly compensated, or their spouses or dependents, the plan also must not discriminate in favor of such employees, or their spouses or dependents, in actual operation. Accordingly, the extent to which such employees, or their spouses or dependents, as a group, utilize plan benefits must be compared to the extent to which all other employees, or their spouses or dependents, as a group, utilize plan benefits. . . . [A] persistent pattern of greater relative utilization of plan benefits by the group of employees who are officers, shareholders, self-employed or highly compensated, or their spouses or dependents, may be evidence that the plan discriminates in favor of such employees and is not for the benefit of employees generally.¹¹⁷

The same proposed regulation also provides, "[t]he extent to which members of the limitation class, as a class, utilize plan benefits shall be taken into account,"¹¹⁸ for purposes of determining whether the amount of contributions "on behalf of"¹¹⁹ the suspect class exceeds the allowable amount.¹²⁰ Whether Treasury or the courts should or

¹¹³ See I.R.C. §§ 120(c)(1), 129(d)(2), 105(h)(2)(B) (benefits only). See also I.R.C. § 125(b)(1)(B) (amended by 1986 Tax Reform Act). Cf. I.R.C. § 79(d)(2)(B) ("the *type and amount* of benefits available under the plan do not discriminate. . . .") (emphasis added). For discussion of the ambiguities inherent in the term "benefits," see *supra* note 72.

¹¹⁴ See I.R.C. § 401(a)(4).

¹¹⁵ See Wiedenbeck, *supra* note 60, at 218-19. Indeed, if what is being provided is group insurance, the employer may have no way of knowing the premium payable with respect to a given employee.

¹¹⁶ Prop. Treas. Reg. § 1.120-2(e)(3), *supra* note 109.

¹¹⁷ *Id.* § 1.120-2(e)(3)(ii).

¹¹⁸ *Id.* § 1.120-2(f)(5)(i).

¹¹⁹ *Id.*

¹²⁰ The concentration test for group legal services plans limits the amounts "contributed under the plan" that "may be provided for the class" of 5% owner-employees. I.R.C. § 120(c)(3). The proposed regulations separately describe these amounts, but do not necessarily differentiate them from "contributions" for purposes of the more gen-

would take the same approach when examining a plan providing benefits other than legal services remains uncertain because of the unique wording of the legal services statute.

Congress explicitly (and uniquely)¹²¹ provided in the statute, “[a]llocations of amounts contributed under the plan shall . . . take into account the expected relative utilization of benefits to be provided from such contributions.”¹²² Moreover, no attempt has yet been made to quantify “a persistent pattern of greater relative utilization.”¹²³ Thus, even if the method of allocation could be decided upon, the ultimate consequences of the allocations would still be in doubt.

Congress attempted to eliminate both of these ambiguities or defects from the latest version of the benefits test, codified in section 89. In essence, the new benefits test is just a more precise version of the nondiscriminatory benefits rule described above. It mandates that “the average employer-provided benefit received by [non-highly compensated] employees” from all plans of the same type¹²⁴ equal at least 75% of the “average employer-provided benefit received by highly compensated employees” under such plans.¹²⁵ The statute defines “average employer-provided benefit” as a fraction, the numerator of which is “an amount equal to . . . the aggregate employer-provided benefits received by” the category of employees being tested,¹²⁶ and the denominator of which is the number of employees in that category.¹²⁷

All employees are included within a category (and thus the denominator of the fraction), whether or not covered under any such plan,¹²⁸ unless specifically excluded by statute.¹²⁹ In addition to the

eral nondiscrimination test. Compare Prop. Treas. Reg. § 1.120-2(e), *supra* note 109 with *id.* § 1.120-2(f).

¹²¹ No other fringe benefit statute contains such a provision. On the other hand, no fringe benefit statute explicitly provides that utilization rates cannot be considered when testing for discrimination. Two statutes provide that utilization rates for different *types* of assistance made available under a program are not grounds for finding discrimination, see I.R.C. §§ 127(c)(5)(A), 129(e)(6), but those provisions are integration rules, which allow the nondiscrimination test to be satisfied by aggregating utilization rates for different types of assistance in a given program, rather than making all utilization rates irrelevant. In fact, it is logical to conclude, as does one commentator, that these provisions imply by negation that “participants’ relative total utilization of all items of in-kind compensation available under the plan is relevant to the amount nondiscrimination test.” Wiedenbeck, *supra* note 60, at 225. But see *supra* note 72.

¹²² I.R.C. § 120(d)(3).

¹²³ Prop. Treas. Reg. § 1.120-2(e)(3)(ii), *supra* note 109.

¹²⁴ For a definition of “plans of the same type,” see *supra* note 84.

¹²⁵ I.R.C. § 89(e)(1).

¹²⁶ The two relevant groups are highly compensated and nonhighly compensated employees. See I.R.C. § 89(e)(2).

¹²⁷ *Id.*

¹²⁸ I.R.C. § 89(e)(2)(B).

general statutory exclusions, section 89 allows employers to elect two additional exclusions for purposes of applying this benefits test to health insurance plans. First, the employer may disregard any employee who (together with spouse and dependents) receives "core benefits"¹³⁰ under another employer's health plan.¹³¹ Second, employers may elect to test health benefits provided spouses and dependents of employees separately from those provided individual employees. If they do so elect, they may ignore those employees with a spouse and/or dependents who are covered by another employer's core benefits health plan and employees with neither spouses nor dependents when testing spouse/dependent benefits¹³² for discrimination.¹³³

The numerator of each fraction contains the sum of the amounts of employer-provided benefits distributed to the employees in the category over the taxable year. Computing this number, of course, requires being able to ascertain the value or amount of benefits provided to each employee. Section 89 explains how to do this; the methods it provides differ depending on whether the benefit at issue is health or group-term life insurance, or some other benefit. In the case of health or group-term life insurance, the amount of the benefit is "the value of the coverage";¹³⁴ for other types of

¹²⁹ See I.R.C. § 89(h); see also *supra* note 73 (describing exclusions).

¹³⁰ Although the statute does not define the term, in its explanation of the 1986 Tax Act, the Joint Committee staff describes "coverage for dental, vision, psychological and orthodontia expenses and elective cosmetic surgery" as "noncore accident and health benefits." 1986 GENERAL EXPLANATION, *supra* note 64, at 799.

¹³¹ I.R.C. § 89(g)(2)(A)(i).

¹³² I.R.C. § 89(g)(2)(A)(ii). *But see* I.R.C. § 89(g)(2)(E) (limiting exclusion of nonhighly compensated employees to plans providing immediate election of coverage for change of circumstances such as loss of other coverage or marriage).

¹³³ An employer electing to use either of these exclusions must maintain "sworn statements" by employees of their marital and coverage status. I.R.C. § 89(g)(2)(B). Large employers may meet this requirement through the use of as yet largely unexplained "valid sampling techniques." These techniques must be approved by Treasury subject to the minimum standards established by Congress in the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3021(a)(3), 102 Stat. 3342 (to be codified at I.R.C. § 89(g)(7)). In the absence of written statements, the Code treats each highly compensated employee of electing employers as if covered by another employer's plan and without a spouse and dependents. The opposite assumptions apply to a nonhighly compensated employee. I.R.C. § 89(g)(2)(C).

¹³⁴ I.R.C. § 89(g)(3)(A)(i). The statute also explains how to derive the value of "coverage." For example, in valuing health insurance, section 89 provides procedures prescribed by the Secretary "... shall—(i) set forth the values of various standard types of coverage involving a representative group, and (ii) provide for adjustments to take into account the specific coverage and group involved." I.R.C. § 89 (g)(3)(B). (Inasmuch as Treasury has been unable to issue these figures, Congress postponed the effective date of this valuation standard to "the later of January 1, 1991, or the date 1 year after the Secretary . . . first issues such valuation rules" See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3021(c)(1), 102 Stat. 3342, 3363. In the meantime, employers may select "any other reasonable method." *Id.*) This method,

plans, it is “the value of the benefits.”¹³⁵ The juxtaposition of “the value of the coverage” and “the value of the benefits” suggests that the two phrases mean different things—specifically, that the term “benefits” in this context refers to only those payments made to or on behalf of an employee under the plan.

In prior eligibility and (perhaps) nondiscriminatory benefits rules, the same word referred to the cost of making such benefits available in the event a need arose.¹³⁶ Congress could not have intended the old meaning here because the phrase “the value of the benefits” would mean the same thing as “the value of the coverage” and Congress had no reason for providing two separate definitions of “employer-provided benefit.” To make sense of the dual definition, then, we must interpret the term “benefits” more narrowly to include only utilized opportunities. The fact that, as part of the same act, Congress added a similar benefits test to the exclusion for dependent care assistance supports the argument for this interpretation of “benefits.” When describing this new addition to the dependent care statute, the Joint Committee Staff noted, “[t]his benefits test was intended to apply notwithstanding the provision providing that utilization rates cannot cause a dependent care assistance program to fail to qualify.”¹³⁷ Because the dependent care benefits test is “the same benefits test applicable to statutory employee benefits plans . . . with two modifications,”¹³⁸ it stands to

however, only leads to the assignment of a value to all the coverage provided under a plan (a figure which most employers could derive rather easily by looking up their insurance premiums!) and not the value of each individual’s coverage (a figure needed whenever a plan covers some highly compensated and some nonhighly compensated individuals, unless, although nominally members of one plan, the different employee groups should be treated as receiving benefits under two different plans for valuation purposes). One possibility is that each individual’s benefit under a plan would be equal to the total cost divided by the number of employees covered by the plan. Although understating the value of coverage provided less healthy employees, this method is consistent with the rule provided for valuing group-term life insurance benefits. That rule states that “in determining the value of coverage under a group-term life insurance plan, the amount taken into account . . . shall be based on the cost of the insurance determined under section 79(c) for an employee who is age 40.” I.R.C. § 89(g)(3)(C). Of course, this allocation method fails to prevent the “abuse” described *supra* text accompanying notes 104-05.

¹³⁵ I.R.C. § 89(g)(3)(A)(ii).

¹³⁶ See *supra* note 72 (eligibility) and text accompanying notes 113-21 (benefits).

¹³⁷ 1986 GENERAL EXPLANATION, *supra* note 64, at 810 n.12. The footnote also points out that “[a] technical correction may be needed so that the statute reflects this intent.” *Id.* This correction was included in the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1011B(a)(15)(B), 102 Stat. 3342, 3485 (to be codified at I.R.C. § 129(d)(7)(B)).

Note that both the Staff and Congress interpret section 129(e)(6) as forbidding any sort of utilization test, despite the narrower reading (described *supra* note 121) suggested by its carefully limited language.

¹³⁸ 1986 GENERAL EXPLANATION, *supra* note 64, at 810.

reason that the statutory employee benefits benefit test takes actual utilization and not mere coverage into account.

The new benefits test allows employers one additional option. Instead of computing the average employer-provided benefit for each type of plan, employers may elect to compute a single average employer-provided benefit for *all* of their "statutory fringe benefit plans" taken together.¹³⁹ Thus, benefits provided employees under one type of plan may overcome deficiencies in the average employer-provided benefit provided nonhighly compensated employees under another type of plan. However, because meeting section 89's benefits test does not excuse "elective" statutory fringe benefit plans from the requirement of fulfilling any applicable concentration of benefits test,¹⁴⁰ and because too gross a disparity in the distribution of benefits may cause a plan to fail the applicable concentration test,¹⁴¹ the allowance of aggregation for purposes of section 89's benefits test may not save plans from unfavorable tax treatment.

Finally, section 89 provides an alternative test so employers may avoid both its general benefits test and the first two parts of its tripartite eligibility test.¹⁴² Under this alternative test, the nondiscriminatory nature of health and life insurance plans is established if the plan¹⁴³ covers 80% of the nonhighly compensated employees and avoids any eligibility provision which (by its terms or otherwise)

¹³⁹ I.R.C. § 89(g)(4)(A). For a list of benefit plans falling within the definition of "statutory employee benefit plans," see *supra* note 81. Apparently, an employer can aggregate a subset of its statutory fringe benefit plans for testing purposes, leaving the remainder to be tested in a separate computation. Once it elects to aggregate one plan providing benefits excludable under a particular Code section, however, it must aggregate all of its plans providing benefits excludable under that Code section. See 1986 GENERAL EXPLANATION, *supra* note 64, at 806-07.

Health plans, however, must meet the benefits test by themselves to qualify as non-discriminatory. I.R.C. § 89(g)(4)(B). After establishing their nondiscriminatory status, the taxpayer may aggregate the value of all benefits provided under health plans with the value of benefits provided under other types of plans to determine whether the other plans are discriminatory. 1986 GENERAL EXPLANATION, *supra* note 64, at 806-07. This is not always advantageous because the special exclusions applicable to health plans, see *supra* text accompanying notes 130-33, disappear when testing such plans along with other plans. 1986 GENERAL EXPLANATION, *supra* note 64, at 807. Thus, because of the variable definitions of "excludable employees," the combined plans may fail nondiscrimination tests which either type of plan could pass individually.

¹⁴⁰ I.R.C. § 89(j)(7).

¹⁴¹ See *supra* text accompanying notes 106-12 (discussing operation of various concentration tests).

¹⁴² I.R.C. § 89(f).

¹⁴³ The Code provides special rules for allowing, and in certain cases requiring, the aggregation of health plans for benefits testing purposes. See I.R.C. §§ 89(g)(3) & (g)(1)(D). See also *supra* note 91 (describing general allowance of aggregation of "comparable" health plans).

discriminates in favor of highly compensated employees.¹⁴⁴ This simple test, designed for use by small employers,¹⁴⁵ like the other benefits tests applicable to health and group-term insurance plans, ignores the possibility that identical benefits may have substantially different economic consequences for different recipients.

Though nondiscrimination rules in the fringe benefit area are far from perfect (in terms of taxpayers' knowing what they must do to comply with them), it appears that some of the nondiscrimination rules applicable to the fringe benefit sections of the Code may achieve Congress's intended effect. They will require employers who hope to obtain favorable tax treatment for highly compensated employees' benefits to provide benefits of similar economic value to their lower paid employees. The specification of necessary definitions, the clarification of ambiguous terms, and above all, the provision of bright line standards for the identification of discriminatory programs will all combine to make compliance and enforcement possible. In short, the restrictions may actually restrict some employers' freedom to act as they might wish. But now that nondiscrimination rules will begin to have some bite, it is time to ask what behavior the Code will be encouraging and why. The answers to these questions are not as straightforward as one might wish.

B. The Trickle-Up Effect

Employers can provide very few fringe benefits at no cost,¹⁴⁶ and many of the most common fringes are quite expensive.¹⁴⁷ Although an altruistic employer may be willing to incur such costs on top of its ordinary compensation expenses, an ordinary employer must offset the cost of such fringes against employees' cash wages.¹⁴⁸ Indeed, from the economic perspective of an employer, a fringe benefit plan is a needless expense unless employees are willing to give up enough cash salary to cover the cost of the plan.

¹⁴⁴ I.R.C. § 89(f).

¹⁴⁵ 189 DAILY TAX REP. G-5 (Oct. 1, 1987).

¹⁴⁶ Even those fringe benefits which fall within section 132(b)'s definition of a "no-additional-cost-service" (and which are, therefore, excluded from income under section 132(a)) are costless only when viewed from the narrowest possible perspective. See Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141, 1162-63 & nn.100-05 (1976).

¹⁴⁷ The two most common fringe benefits are life and health insurance. BUREAU OF LABOR STATISTICS, U.S. DEPT. OF LABOR, BULL. 2281, *EMPLOYEE BENEFITS IN MEDIUM AND LARGE FIRMS*, 1986 27 (1987) (health care benefits provided to 95% and life insurance to 96% of employees in large and medium size firms) [hereinafter *EMPLOYEE BENEFITS IN MEDIUM AND SMALL FIRMS*]. For those employees receiving coverage, the median cost for health insurance approximated \$1265 (net of administrative costs). *Id.* at 15, 31.

¹⁴⁸ Adamache & Sloan, *Fringe Benefits: To Tax Or Not To Tax?*, 38 NAT'L TAX J. 47, 60 (1985); Halperin & Tzur, *The Effects of Nontaxable Employee Benefits on Employer Profits and Employee Work Effort*, 38 NAT'L TAX J. 65, 75 (1985).

Otherwise the plan increases the employer's total labor cost and decreases profits. For example, if employees would work for \$1000 in cash or \$950 plus a given amount of health insurance, it would make economic sense for an employer to provide the health insurance only if it could do so for \$50 or less.¹⁴⁹

1. *The Incidence of a Tax Subsidy*

The exclusion of fringe benefits from taxable income makes employees relatively more likely to agree to such trades because it makes fringe benefits appear cheaper than they are in market terms.¹⁵⁰ In order for the trade to be worthwhile, the benefit only needs to be worth more to the employee than the forgone cash salary reduced by the applicable tax. For example, the real choice for an employee in a fifteen percent tax bracket who is deciding between health insurance and \$100 in cash salary is between the health insurance and \$85. The health insurance is obviously more attractive once tax considerations are taken into account (though it might not look like a good trade to the employee in either case).

In the absence of a nondiscrimination rule, the tax subsidy¹⁵¹

¹⁴⁹ Exactly how thrilled an employer will be depends on how much of the savings it can direct to its own benefit and how much will remain with the employee as a *de facto* bonus. The only way the employer can realize a direct cost savings, however, is if it can figure out how much the benefit is worth to the various employees and subtract that value from their wages. The valuation task is not an easy one. The employees themselves are often unable to determine the value of such benefits because of uncertainty as to the actual amount provided or inability to consider in isolation one component of an overall wage package. Even when employees can assess a benefit, they have an incentive to misrepresent their calculation in hopes of negotiating a better deal with the employer. See Popkin, *The Taxation of Employee Fringe Benefits*, 22 B.C.L. REV. 439, 448-49 (1981). Moreover, even with perfect information, an employer may have difficulty reducing employees' salaries by as much as the benefit's value. See *id.* at 451-52. In most cases, therefore, an employer is unlikely to retain the entire differential for itself. *Id.* at 452. On the other hand, letting the worker retain some of the differential has offsetting advantages for the employer. See Halperin & Tzur, *supra* note 148, at 75. For example, it may raise employee morale and induce employees to work harder.

Of course, any extra profits generated by the reduction in labor costs would be subject to income tax. This additional tax liability is not a "tax disadvantage," however. Although the employer's taxes would be higher than the taxes due if the employee retained the differential, the employer is still better off by the amount of the differential minus the extra tax obligation.

¹⁵⁰ See Katz & Mankiw, *How Should Fringe Benefits Be Taxed?*, 38 NAT'L TAX J. 37, 38 (1985); Adamache & Sloan, *supra* note 148, at 47. After running an empirical study, one commentator argued that, while statistically significant, the effect of tax favoritism on the amount of fringe benefits provided is relatively low. He projects that eliminating the various exclusions entirely would only cause about a 25% drop in the amount of fringe benefits provided. Turner, *Are Taxes Responsible for the Growth in Fringe Benefits?*, 40 NAT'L TAX J. 205, 215 (1987).

¹⁵¹ When Congress declines to tax certain forms of compensation, it clearly subsidizes them. "In effect, the federal government is paying a portion of the employee's wages in order to encourage the employer to provide certain types of benefits to the

can accrue to three parties: the employee receiving the benefit, the employer providing the benefit, and the suppliers of the benefit. Employees can benefit whenever the value of the exclusion exceeds the difference between their employer's cost of providing the benefit and their subjective valuation¹⁵² of its worth (i.e., it exceeds the amount necessary to persuade the employee to forfeit the requisite cash salary in exchange for insurance coverage). Take, for example, an employee in a 15% tax bracket whose subjective valuation of \$100 of health insurance is \$90. Absent a tax benefit, the employee would not agree to trade enough cash for the insurance so that the employer could not recoup his expenses and thus would not purchase the insurance. A government bonus of \$10.01 for choosing insurance would suffice, however, to alter the employee's preferences in favor of the insurance. Because the Treasury forgives the \$15 tax on the \$100 of insurance rather than providing a bonus of \$10.01, the employee gains—and the Treasury loses—an extra¹⁵³ \$4.99 as a result of engaging in the trade.¹⁵⁴

The employee retains this extra \$4.99 only if his employer does not capitalize on it. The employer may try to appropriate some or all of the subsidy for its own benefit by requiring the employee to give up more cash salary to engage in the trade than that necessary to cover the employer's expense of providing insurance.¹⁵⁵ The em-

employees." *Testimony of John E. Chapoton, Assistant Treasury Secretary for Tax Policy before the Senate Finance Committee, reprinted in 19-13 TAX NOTES 1191, 1191 (1983) [hereinafter Chapoton Testimony].* The amount of lost tax revenues is quite large; estimates of lost income tax alone total around \$29 billion (in 1979 dollars). Turner, *supra* note 150, at 215; see also Adamache & Sloan, *supra* note 148, at 54 (estimating 1980 revenue loss at about \$23.6 billion). Of course, increasing the tax rates applicable to taxable income may have recouped much of this "lost" revenue (in other words, if Congress repeals the exclusions it may use the increase in revenues to reduce rates rather than the deficit), exacerbating the distortions caused by the exclusions. See Kusters & Steuerle, *supra* note 26, at 90-91.

¹⁵² Employees benefit to the extent of the difference between the after tax value of their entire compensation package (wages and benefits) with the tax exclusion and the after tax value of the compensation without the exclusion. It is possible to calculate the employees' benefits by estimating the market value of the benefits. However, not all employees value the fringes as the market does. The formula contained in the text thus more accurately represents the value of the exclusion from an employee's perspective. See Clotfelter, *supra* note 26, at 52; but see Yorio, *Equity, Efficiency and the Tax Reform Act of 1986*, 55 *FORDHAM L. REV.* 395, 445 n.358 (1987) (arguing that interpersonal utility differences should be ignored).

¹⁵³ The "extra" is the amount the Treasury loses in excess of the amount necessary to entice the employee to trade cash salary for the fringe benefit.

¹⁵⁴ The amount of the "wasted" tax subsidy is uncertain, because, in the absence of a set of compensation packages designed in a world without a tax subsidy, there is no alternative for comparison. The most recent published study, however, suggests that the subsidy "is not a cost-effective means to employ." Turner, *supra* note 150, at 215.

¹⁵⁵ See Lubick Testimony, *supra* note 22, at 26. Of course, the employer may decide it could benefit more from the increased productivity generated by a better paid, happier employee. See Halperin & Tzur, *supra* note 148, at 75.

ployer could demand that the employee give up \$105 in cash salary to receive health insurance, for instance, and reduce its labor costs by \$5. The employee would agree to this trade because he values the health insurance more than the \$89.25 left after paying 15% income tax on the \$105. Of course, the employer's gain is the employee's loss; this trade would leave the employee only \$.74 of the surplus.¹⁵⁶ Finally, fringe benefit suppliers are likely to benefit, at least in the short run from the exclusion, because it increases demand for their products and enables them to sell more units or to raise their prices.¹⁵⁷

Even the federal government may benefit from the arrangement, because it might have to provide health benefits if employers do not. The process of designing a public delivery system, to say nothing of raising the revenue to support it, might be more difficult, expensive, or unpleasant for the government than for employers. Even an admittedly defective tax subsidy system, therefore, may be better from the government's perspective.¹⁵⁸

Not everyone benefits from the tax subsidy, however. The clearest losers are employees who receive relatively few fringe benefits from their employers, either because their employers do not offer them benefits or because they decline available benefits. These employees pay tax on a higher proportion of their total compensation than employees who receive part of their income in the form of fringe benefits. Their tax burden is, therefore, disproportionately high.¹⁵⁹

¹⁵⁶ Undoubtedly, employers appropriate some portion of the subsidy; no one appears to believe, however, that employers take it all. *E.g.*, Halperin & Tzur, *supra* note 148, at 75; Yorio, *supra* note 152, at 445. *See also* Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 PA. L. REV. 851, 880 (1987) (discussing tradeoff of pension tax benefits). Some of the reasons for this splitting of the benefit are discussed *supra* note 149. Note that employer appropriation of the benefit solves neither the lost revenue problem, discussed *supra* note 151, nor the horizontal inequality problem. Although additional profits generated by the appropriation would be taxable, the revenue raised would be at most 34% (the highest marginal tax rate) of the forgone revenues (since the base for assessing the tax would be only the tax revenue forgone rather than the amount excluded from income). Likewise, although no employee would be favored if the tax benefit were "competed away," employers able to provide such benefits would be favored relative to other employers because of their lower labor costs. *See* Lubick Testimony, *supra* note 22, at 26; Ferguson, *Income Tax Treatment of Employee Fringe Benefits*, 74 NTA-TIA 97, 98 (1981).

¹⁵⁷ Although commentators have investigated the relationship between the exclusion of employer-provided health insurance from income and the rise in health care costs extensively, research has led to more questions than answers. *See, e.g.*, Adamache & Sloan, *supra* note 148, at 56-57; Feldstein, *supra* note 26, at 253-55; Kusters & Steuerle, *supra* note 26, at 90.

¹⁵⁸ *See* Lubick Testimony, *supra* note 22, at 26 (some fringe benefits have "a social welfare purpose"); Adamache & Sloan, *supra* note 148, at 48.

¹⁵⁹ This result is particularly evident (though no more true) if one assumes Congress raises tax rates to recoup tax revenues lost to the various fringe benefit exclusions. For

A disproportionate number of employees receiving below-average fringe benefits are relatively poor.¹⁶⁰ Several reasons exist for this disparity. One reason is quite obvious: the poorer the individual, the more likely he is to need cash rather than fringe benefits (which usually are nontransferable). To take an extreme example, consider what would happen if an employee working for compensation just above the minimum wage (and with little or no income from other sources) were asked whether he would trade some cash salary for legal insurance. Such a trade would involve a gain of legal insurance but, almost surely, the loss of the means to purchase adequate amounts of food.¹⁶¹ The lower an employee's income the less likely he is to value fringe benefits as highly as the items he could purchase with cash.¹⁶² In the face of such a valuation differential an employee will not voluntarily agree to trade cash for fringe benefits. By contrast, the higher an individual's income, the more likely he is to think a trade is worthwhile. High income individuals have enough discretionary income to invest in, and often have acquired a taste for, benefits such as legal insurance, life insurance, and health insurance. Especially if the terms offered by employers compare favorably to those employees could obtain themselves, as they often will,¹⁶³ trading cash salary for fringes is an attractive option for these employees.

The difference in the willingness of employees at different income levels to trade cash salary for fringe benefits is exacerbated by the tax subsidy for fringe benefits. The progressive rate structure of

example, suppose Congress increases marginal tax rates from 24% to 28% to avoid a shortfall of revenue because taxpayers, on average, receive 16% of their compensation in the form of tax free fringe benefits. Instead of receiving \$1000 and incurring a \$240 income tax liability, the average taxpayer is treated as receiving \$840 and pays \$235 in taxes. Taxpayers who receive all \$1000 in cash, however, end up with a tax liability of \$280—or \$45 more than the “average” similarly well paid taxpayer. The detriment to taxpayers who do not prefer tax-favored goods occurs not only in the context of fringe benefits but also of public highways, housing, and other publicly-financed or tax-favored goods.

¹⁶⁰ Adamache & Sloan, *supra* note 148, at 51-52 (“employer contributions to fringe benefits increase as employee (tax unit) income increases”); Kosters & Steuerle, *supra* note 26, at 88 (“The amount of many nontaxed fringe benefits are positively related to wage levels.”).

¹⁶¹ A related problem faces the employer; only cash salary, and not untaxed benefits, count towards the legal minimum wage. Thus, employers are effectively forbidden from engaging in a swap of cash salary for benefits even with those low wage employees who would agree to one. See Kosters & Steuerle, *supra* note 26, at 88.

¹⁶² See *id.* (“many of the fringe benefits that are not subject to taxation are likely to be income elastic because they are closer to being luxury goods than necessities”).

¹⁶³ At the very least, most employers will provide benefits through group plans, which tend to be much cheaper than individually tailored arrangements. See, e.g., Adamache & Sloan, *supra* note 148, at 47; Werther, *A New Direction in Rethinking Fringe Benefits*, MSU BUS. TOPICS 35, 39 (1974); Yerman, *Fringe Benefits: Tax Shelter for the Working Man*, 1 COLUM. J. L. & SOC. PROBS. 56, 57 (1965).

the tax system¹⁶⁴ means the tax advantage of receiving fringes instead of cash salary increases as income rises. The choice for a 15% marginal tax rate taxpayer is, as we saw above, between \$85 in cash and a \$100¹⁶⁵ fringe benefit. For a taxpayer in a 28% bracket, the relevant comparison is between the benefit and \$72 in cash.¹⁶⁶ The tax system thus provides relatively low income taxpayers much less incentive to choose fringe benefits rather than cash salary.

Because both an employee's valuation differential tends to decrease and the tax incentive offered by the government for making such trades tends to increase as the employee's income rises, it follows quite naturally that an employee's willingness to trade at least the employer's costs in cash to receive the benefit also increases with income.¹⁶⁷ The chances that the employer can recoup its cost of providing such benefits, if not actually profit from doing so, correspondingly increase with the employee's income.¹⁶⁸ It is hardly surprising, therefore, that profit maximizing employers tend to provide higher paid employees more fringe benefits than lower paid employees.

2. *The Incidental Effects of Nondiscrimination Rules*

Congress intended the nondiscrimination rules to reverse the tendency of employers to provide higher paid employees more fringe benefits than lower paid employees. The rules require employers to make a choice; they may provide the same or similar benefits to lower paid employees as they voluntarily provide higher paid employees, or they may forfeit some or all of the tax advantage realized by employees receiving fringe benefits. The costs of these alternatives are different for different employers.

The choice is easy and costless for those employers who find that they can meet the nondiscrimination tests without providing ad-

¹⁶⁴ Despite the latest round of tax reform, which flattened out the rate schedule by lowering the top marginal rate and reducing the number of tax brackets to two, 15% and 28%, the federal income tax is still progressive; that is, both marginal and average tax rates increase in conjunction with income. See Yorio, *supra* note 152, at 438-39. Indeed, due to the "phasing-out" of a variety of tax deductions and allowances the new rate schedule is more progressive than the one it replaced over certain income ranges. See Coven, *Congress as Indian-Giver: "Phasing-Out" Tax Allowances Under the Internal Revenue Code of 1986*, 6 VA. TAX REV. 505, 505-06 (1987) (arguing that phase-outs are inequitable and inefficient).

¹⁶⁵ Measured by the employer's cost, assuming the employer passes the entire tax benefit on to the employee.

¹⁶⁶ If the employee received the \$100 spent by the employer to provide the fringe benefit in cash, only \$72 would remain after the employee paid a 28% tax.

¹⁶⁷ Employees may be willing to give up more than the cost of the fringe benefit, because they obtain a tax reduction along with it.

¹⁶⁸ This effect works in the opposite direction, of course, as an employee's income decreases.

ditional benefits to employees unwilling to give up in cash salary at least the cost of providing benefits. This possibility arises because even the most stringent nondiscrimination rule does not require either uniform access to benefits or the distribution of benefits to all employees, but requires only that some proportion of nonhighly compensated employees have access to and benefit from a plan. Also, the definition of nonhighly compensated employees is broad enough to encompass many employees willing to engage in voluntary trades. Depending on the composition of the work force and the percentage of highly compensated individuals covered by the plan, the requisite percentage of nonhighly compensated employees may be drawn only from this group.¹⁶⁹ Finally the likelihood that employers will be able to comply without cost also increases because of their ability to exclude employees under age twenty-one and part-time and seasonal employees, two of the traditionally lowest paid groups, from consideration altogether.¹⁷⁰

To the extent meeting the nondiscrimination standards requires employers to provide benefits to employees unwilling to absorb their full cost in the form of a salary reduction, the nondiscrimination rules impose additional costs on the employers. The employer must absorb the costs of providing benefits to those employees (essentially redirecting its fringe benefits profit to nonhighly compensated employees) or lose much if not all of its ability to profit from providing benefits. Much of the excess "value"¹⁷¹ which makes profits possible stems from the tax advantage provided recipients of benefits. The value disappears if the tax advantage disappears.¹⁷² Even excess value attributable to the vol-

¹⁶⁹ The higher the percentage of employees paid at or close to minimum wage levels, the more likely it is that the employer will have to provide nonhighly compensated employees some subsidy to encourage their participation and maintain requisite coverage and benefit levels. By contrast, the better paid the nonhighly compensated workers are, the more likely it is that the employer can find the requisite number willing to engage in a voluntary trade. Allowing only a small percentage of highly compensated employees to benefit from a plan would also make voluntary trading more likely. The savings achieved by eliminating subsidies to low income employees may, however, be outweighed by the loss of opportunities to engage in favorable trades with highly compensated employees.

¹⁷⁰ See I.R.C. § 89(h)(1)(B)-(D).

¹⁷¹ This excess value consists of the difference between the employee's subjective valuation of the benefit (or his cost of purchasing it from someone other than his employer, if lower) and the employer's cost of providing the benefit. See *supra* text accompanying notes 155-56.

¹⁷² Most employees could, if they tried hard enough, obtain many of the benefits provided by their employers at favorable group rates by affiliating themselves with a non-employer group. See Adamache & Sloan, *supra* note 148, at 47. Given the existence of this alternative, the discrepancy between an employer's cost of providing benefits and their employee's valuation (which cannot exceed the cost of self-provision) probably comes from the tax advantages for recipients of employer-provided fringes.

ume discount an employer obtains as a large customer declines in the absence of a tax advantage because fewer employees will want to participate in the fringe benefit plan.

The choice of a particular employer will depend on the relative costs of the alternatives. On the one hand, if the costs of bringing the plan into compliance with the nondiscrimination rules are greater than the savings the employer derives from providing fringe benefits to employees, the employer is likely to discontinue the program. On the other hand, if the costs of compliance are lower, it is likely to extend the program to cover the required number of under-contributing employees.¹⁷³ Paradoxically, the result of effective nondiscrimination rules will in many cases be shrinkage of fringe benefit plan coverage to the class of employees who are willing to make the necessary trade in the absence of a tax advantage—the richest, not the poorest, employees.¹⁷⁴

Thus, the nondiscrimination rules will often have a trickle-up rather than a trickle-down effect. Instead of merely forcing the benefits of fringe benefit plans to be distributed to lower level employees, the nondiscrimination rules may impose lower paid employees' preference for cash salaries on the more highly paid employees. The ultimate effect of the trickle-up effect will be to increase revenue for the Treasury because fewer nontaxable fringe benefits will survive.

Even in cases where the trickle-up effect does not immediately lead to the termination of a fringe benefits plan, the imposition of a nondiscrimination rule may subtly sabotage such plans and make them less sustainable over the long term. It may do this because of the interplay between the nondiscrimination rules' stripping away of excess benefits generated by high level employees and the public

¹⁷³ Because the recent decrease in marginal tax rates, *compare* I.R.C. § 1 (1985) (top rate for individuals 50%) *with* I.R.C. § 1 (top rate for individuals 28%), also has the effect of decreasing the tax advantage of being paid fringe benefits rather than cash, one suspects that employers will increasingly choose to eliminate fringe benefit plans.

¹⁷⁴ Of course, that outcome may be acceptable because, in contrast to the present system, no outlay of government funds would subsidize the health insurance. *See supra* note 151. The outcome would be an example of the unequal distribution of wealth. As long as some lower paid workers continue to receive tax-free, employer-provided benefits, however, lower paid workers who lose their benefit plans as a result of the operation of the nondiscrimination rules will (and should) regard these rules as extremely unfair. From their perspective, the rules force them to give up the small subsidy provided by their highly paid co-workers' tax savings (which have been appropriated by their employer, see text accompanying notes 171-72) because it is too small, while no more deserving workers at other firms continue to collect larger subsidies. The rules hurt those who are already the worst off; to the extent their plight results from the structure of their employment unit rather than abuse of the tax rules (as it well might, see *supra* note 110 (describing differential impact of benefits test based on personnel structure of firm)), it is hard to justify.

choice problem that affects all group decisionmaking. The next section discusses how public choice affects responses to nondiscrimination rules.

C. The Public Choice Effect

1. *Expected Effects: The Theory Revisited*

As explained in Part I, it is impossible to find a “best” choice when individuals with multi-peaked preferences must choose among three or more alternatives. As a result, no decision reached by the group is truly satisfactory to its members, and they may, out of sheer frustration, decide not to make any choice at all.

To the extent this public choice dilemma afflicts the choices between and levels of different benefits offered in a fringe benefit plan, it reduces the attractiveness of such plans. Dissatisfaction with a plan’s offerings reduces employees’ willingness to pay for it through salary reductions; employers gaining little benefit from the plans as a result of the trickle-up effect of the nondiscrimination rules may then find it cheaper to discontinue the plans altogether.

In the fringe benefit context, the impossibility of reaching a “best” solution does not necessarily mean that the employer will opt for an all-cash compensation package. A majority, or even all of the employees, might prefer to receive several fringes rather than their cash equivalent. Even if a majority of employees prefers another fringe to the one the employer currently provides, the same majority might also prefer the current fringe if the alternative is a no-fringe, all-cash compensation package.¹⁷⁵ If enough employees value enough of the fringes at less than the amount of cash salary (after reduction by the appropriate tax liability), however, the employer is better off providing all cash compensation.

Consider, for example, the likely result if the employees in the example in Part I subjectively valued the three benefits, each of which the employer can provide at a cost of \$100, as follows:

¹⁷⁵ Suppose, for example, employees A, B, and C from Table 1 attached the following values to the three fringe benefits:

Table #2

<u>Employee</u>	<u>Health Insurance</u>	<u>Life Insurance</u>	<u>Dependent Care</u>
A	\$90	\$60	0
B	\$ 0	\$80	\$50
C	\$90	\$60	100

Although a vote among fringes would lead to the deadlock described in Section I, if the group faced an explicit choice of health insurance or cash, a majority (A and C) would favor the health insurance over the cash, whether they were in the 15% or 28% tax bracket, because the \$90 value they attach to the insurance is greater than the \$85 or \$72 they would realize, after payment of income taxes, from \$100 of cash.

Table #3

<u>Employee</u>	<u>Health Insurance</u>	<u>Life Insurance</u>	<u>Dependent Care</u>
A	\$100	\$ 60	\$ 50
B	\$ 10	\$100	\$ 15
C	\$ 60	\$ 40	\$100

If all three employees are in the 28% tax bracket, the cash salary paid to each in the absence of a fringe benefit would be worth \$72. As no single benefit is worth more than \$72 to two or more employees, a majority of the employees would prefer cash to any benefit, and the employer would be well-advised to provide only cash compensation.¹⁷⁶

As this example demonstrates, however, there is another solution to the dilemma.¹⁷⁷ The employer might provide two fringe benefits rather than one in return for an appropriately large reduction in the employees' cash salary—say, \$200. If so, employees A and C could form a majority coalition supporting a fringe benefit package consisting of both life insurance and dependent care. Each would be slightly better off with this package of benefits than with \$200 of additional cash salary. The cash would be worth only \$144 to them after payment of taxes, while the benefit package would be worth \$150 to A and \$160 to C.¹⁷⁸ However, it is precisely coalitions such as this which the nondiscrimination rules make difficult to form. Formation of a coalition necessarily involves opting for a relatively costly benefit package. The more costly the package, the less likely it is that lower-paid employees will find the entire package attractive. Consider, for example, what would happen to the coalition

¹⁷⁶ The employer would be unlikely to recoup the full cost of providing the fringe benefit via reductions in employees' cash salaries in such a situation. The net result, therefore, would be an increase in the employer's total labor costs and a corresponding decrease in net profits. Cf. *supra* text accompanying note 149.

¹⁷⁷ This solution is not always available. For beneficial trades to be possible, the intensity of the individuals' preferences must vary. D. MUELLER, *supra* note 7, at 49. Consider the outcome if, in the above example, the \$100 values remained the same and all the other values became \$44 (i.e. \$28 below the value of the cash). There is no trade now preferred by a majority.

¹⁷⁸ In the political science literature, this trading process is called "logrolling." See, e.g., R. MUSGRAVE & P. MUSGRAVE, *supra* note 9, at 119. Commentators split on whether "logrolling" is a valuable democratic process or an evil to be prevented whenever possible. Compare *id.* at 119 (logrolling is a "constructive factor in decision making") with Riker & Brams, *The Paradox of Vote Trading*, 67 AM. POL. SCI. REV. 1235 (1973) (recommending reforms to eliminate logrolling). Logrolling can either increase or decrease the welfare of the community as a whole. Where, as in the text's example, the trades produce less gains for the traders than losses for the nontraders, it is tempting to believe that overall welfare has been reduced, although interpersonal utility comparisons are, of course, a minefield. Such trades are surely capable of raising net welfare. For a more complete discussion of the opportunities provided by and problems associated with logrolling, see D. MUELLER, *supra* note 7, at 49-58.

described above if A were in the 15% tax bracket for purposes of the second fringe benefit election.¹⁷⁹ The package would now be worth less to A than all cash compensation and the coalition would fall apart.¹⁸⁰ Thus, the nondiscrimination rules intensify the depressive effect of the public choice constraint on use of fringe benefits.

Moreover, the nondiscrimination rules may further discourage use of fringe benefit compensation by reducing the advantages of fringe benefits for employers and relatively highly paid employees—natural supporters of fringe benefits. By requiring that some of the benefits of the tax advantage provided for fringes be diverted to employees who, if asked, would prefer cash salary to fringes,¹⁸¹ the nondiscrimination rules take away some of the incentive for the remaining parties to choose benefits over cash. As a result, those parties (highly paid employees) will find cash compensation less objectionable and perhaps even an attractive option.

Divergences in employees' opinions as to the desirability of a particular plan impose their own costs on the sponsoring employer. Even in those situations where a coalition can be formed to force adoption of a benefit package, it is unlikely that the package will make every employee better off. There will be losers, like employee B in the example. The employer will have to either assuage the ill feelings of B by providing concessions in some other area, tolerate expression of B's discontent, or lose B to an employer who offers more cash and fewer fringe benefits. None of these alternatives is costless. Nondiscrimination rules limit the benefits an employer can obtain from fringes and make it more likely that the costs of providing the fringe benefits will outweigh the benefits to the employer. Employers might, therefore, favor the use of more cash compensation because of nondiscrimination rules. The nondiscrimination rules may also induce employers to divert more of the benefits of the tax advantages to themselves (in order to pay for benefits provided to the less willing, lower-paid, employees) by more sharply reducing higher-paid employees' cash salaries.¹⁸² Higher paid em-

¹⁷⁹ This would occur whenever A's taxable income, in the event he receives all cash salary and no fringe benefits, exceeds the amount of income taxable in the 15% bracket by \$100. In such a case, a 28% tax would apply to the salary A has to give up to receive the first fringe benefit and that salary would be worth only \$72 to A; however, a 15% tax would apply to the \$100 he has to forego to receive the second fringe and it is, therefore, worth \$85 to A.

¹⁸⁰ This example illustrates the phenomenon generally referred to as "the endowment effect."

¹⁸¹ See *supra* note 159-68 and accompanying text.

¹⁸² Although it is always in an employer's interest to reduce employees' cash salaries by the maximum possible amount, employers frequently fail to attain this goal. See *supra* note 149. By increasing the employer's cost of providing such benefits, however, nondiscrimination rules alter the parties' bargaining positions, bringing employers closer to

ployees would then gain less from the trade of cash for benefits.

In the course of cycling from one available benefits package to another, the employer will probably adopt packages that each employee disfavors. To an employee, already reduced benefits of a current wage-fringe package may not be worth the risk of even less desired cash-fringe packages in future years (indeed, perhaps even one less attractive than an all-cash package). As a result, employees might take the position—even in a year when they prefer the proffered cash-fringe package to an all cash package—that more compensation should be in cash form. By decreasing the upside returns from trading cash salary for fringe benefits without ameliorating the downside risks, the nondiscrimination rules further aggravate the depressive effect of the public choice dilemma.

An individual employee's preferences for a particular fringe benefit must be "multi-peaked" for any of these deterrents to fringe benefit compensation to exist. This means that the strength of an employee's desire for health insurance must not be a strong indication of his desire (or non-desire) for life insurance and or legal insurance.

In the real world, most individuals' desires for fringe benefits are likely to be multi-peaked. Whether a particular employee desires a particular benefit depends on such diverse characteristics as the individual's degree of risk aversion, marital status, spouse's employment status, dependent children (both number and age), income level, and taste. Although there may be some rough correlations between a few of these characteristics,¹⁸³ many are completely independent of one another. There are probably as many individuals who rank health insurance and life insurance high among priorities (breadwinners in traditional families, or single parents) as rank them at opposite ends of their preference schedules (sickly single individuals, compared to persons whose employed spouses provide one or both of these benefits for the family).¹⁸⁴ Congress's expansion of the types of fringe benefits that employers may choose undoubtedly exacerbates the problem by allowing an even greater fragmentation among individual employees' preference schedules. Not only must employees decide how much they like health insurance as compared to life insurance, they also must consider where educational assistance and legal insurance, among others, fit in. Fi-

that goal. Cf. Popkin, *supra* note 149, at 452 (employee bargaining power exists "[a]s long as the employer's cost is less than the employee's cash wage equivalent").

¹⁸³ For instance, auto insurance companies have reason to believe that marital status is related to risk aversion. They charge significantly higher premiums to insure young single males than young married males.

¹⁸⁴ The effect of many demographic characteristics on the desire for typical fringe benefits is "ambiguous." Turner, *supra* note 150, at 207.

nally, there is also a question of how much of each benefit to elect. Multidimensional issues such as these almost invariably lead to multi-peaked preferences.¹⁸⁵

2. *Theory Meets Reality: The Impact of Cafeteria Plans*

As the preceding section explains, the presence of nondiscrimination rules undoubtedly can aggravate the effects of the "public choice constraint" on the provision of fringe benefits. Whether the nondiscrimination rules adopted in the fringe benefit area in fact have this effect is more questionable. None of the rules requires employers to provide exactly equal benefits of each type to all employees; rather, most only require employers to provide each type of benefit to approximately the same proportion of higher and lower income employees.¹⁸⁶ Thus, if the highly compensated employees and nonhighly compensated employees share similar prefer-

¹⁸⁵ See D. MUELLER, *supra* note 7, at 195; accord R. MUSGRAVE & P. MUSGRAVE, *supra* note 9, at 114.

Although preferences for fringe benefits are doubtlessly multi-peaked across the population, individual employees could theoretically avoid the problems associated with multi-peaked distribution by seeking work where other like-minded employees are employed. The impossibility theorem has no application to choices made by groups of individuals with homogeneous tastes, regardless of the heterogeneity of the surrounding population. And, indeed, one senses that to some extent self-selection of this type already exists. For example, people who particularly enjoy travel tend to work for airlines and individuals who enjoy fashion often work for fancy clothing stores. It is hard to envisage, however, such voting-with-their-feet as a solution for more than a few extreme preferences. Restraints on mobility and the lack of adequate information about the alternatives often fetter individuals' choices. See Leslie, *Labor Bargaining Units*, 70 VA. L. REV. 353, 357, 362-63 (1984); see also Popkin, *supra* note 149, at 448 (employees do not know the value of benefits provided by their own employers). Moreover, individuals' preferences for particular fringes tend to vary over time. Dependent care, for example, can be a very valuable benefit when an employee has a small child, but of absolutely no benefit in later years. The value of certain types of health insurance will also change as the employee ages. For example, maternity coverage becomes less important with age, while vision care becomes more important. Thus, over time, the consensus collapses unless a substantial majority of the employees are at the same stage in their course of desires for the particular benefit, progress to the next stage at the same rate, and are able to limit new entries to similar individuals. Cf. D. MUELLER, *supra* note 7, at 55 (discussing difficulties of maintaining a consensus over time as to the set of public goods offerings in a community when migration is possible). Although some employees might migrate out of the community when this happens, thus leading to the re-homogenization of the community, employees' acquisition of job-specific skills and seniority rights tends to make such moves less attractive and hence less likely. See Adamache & Sloan, *supra* note 148, at 48; Leslie, *supra*, at 357. A substantial collection of public finance literature details the efficacy (and non-efficacy) of self-selection as an escape from the dilemma posed by the Arrow Theorem. See, e.g., A. HIRSCHMAN, EXIT, VOICE, AND LOYALTY (1970); Buchanan & Goetz, *Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model*, 1 J. POL. ECON. 25 (1972); Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956). D. MUELLER, *supra* note 7, at 125-47, contains an excellent and largely non-technical survey of this literature.

¹⁸⁶ See *supra* text accompanying notes 64-145 (describing rules).

ences,¹⁸⁷ employers could neutralize the effect of the public choice constraint by providing employees with benefits in accordance with those preferences.

In fact, Congress provided employers with a mechanism to do exactly that at about the time it began adding nondiscrimination rules to the fringe benefits statutes. The mechanism is called a "cafeteria plan." Section 125 of the Code first authorized the mechanism in 1978.¹⁸⁸ A cafeteria plan is not itself a fringe benefit; rather, it is a mechanism for the delivery of fringe benefits to employees. What makes the mechanism special is the amount of choice it places in the hands of individual employees. Cafeteria plans allow employees to select, on an individual basis, between cash salary¹⁸⁹ and any

¹⁸⁷ That is, approximately the same proportion of highly compensated and nonhighly compensated employees would engage in a voluntary trade for each type of fringe benefit.

¹⁸⁸ Revenue Act of 1978, Pub. L. No. 95-600, § 134(a), 92 Stat. 2763, 2783. Section 125 provides that "no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan." *Id.* Enactment of the statute followed years of wrangling among Congress, Treasury, and taxpayers over whether the benefits provided under such a plan should have the same tax advantages as employer-provided benefits (i.e., the exclusion from the recipients' income if certain other conditions were fulfilled). Although earlier administrative pronouncements and court decisions held to the contrary, *see Irish, Cafeteria Plans in Transition*, 25-12 TAX NOTES 1127, 1133-34 (1984), in 1972, Treasury proposed regulations under section 402 of the Code which made it clear that the "constructive receipt" doctrine treats such benefits as employee-purchased benefits ineligible for the various exclusions—that is, that employees receiving benefits under such plans would be treated as if they had been paid in cash and then utilized that cash to purchase the benefits from their employer. *Id.* at 1134. The regulations dealt with the use of salary reduction agreements to fund pension plans but the same issue arises whenever employees are allowed to choose between cash salary and other fringe benefits. *See* Bassey, *Cafeteria, Medical Reimbursement Plans: Terms Causing Problems as Deadlines Near*, 51 J. TAX'N 334, 336 (1979). Congress temporarily resolved this dispute in 1974, by enacting section 2006 of ERISA. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2006, 88 Stat. 829, 992-93. This section (1) imposed a moratorium on the issuance of final salary reduction regulations, (2) froze the law as of January 1, 1972 for cafeteria plans in existence on June 27, 1974, and (3) provided that benefits under arrangements established after that date be treated as employee, rather than employer, provided. *Id.*; *Irish, supra*, at 1134. Congress twice amended the moratorium on the issuance of regulations to extend its period of application through the end of 1979. *See* Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 1505, 92 Stat. 3097, 3097. Despite some ambiguities in the statutory mandate, section 2006 basically prevented the development after 1974 of new cafeteria plans having taxable and nontaxable options. Cooper & McFadden, *Cafeteria Compensation Plans: The Revenue Act of 1978—The New Ground Rules and Some New Issues*, 34 C.L.U.J. 29, 31 (1980). *See also* Fox & Schaffer, *supra* note 22, at 617-19 (recounting legislative and administrative history of constructive receipt dispute).

¹⁸⁹ *See* I.R.C. § 125(d) (1985) (defining "cafeteria plan"). The 1986 Tax Act broadened the definition of a cafeteria plan to include all schemes in which employees are allowed to choose "among 2 or more qualified benefits" or "among 2 or more benefits consisting of cash and qualified benefits." Tax Reform Act of 1986, Pub. L. No. 99-514, § 1151(d), 100 Stat. 2085, 2504 (codified at I.R.C. § 125(c)(1)(B)). Congress reversed the change after realizing that "to make the provision effective as a practical matter [it

of the various nontaxable fringe benefits that comprise the plan's "menu" of offerings.¹⁹⁰ In short, cafeteria plans allow each employee to fashion his ideal fringe benefit package, with little or no consideration for the choices made by his fellow employees.¹⁹¹

Cafeteria plans have the potential to nullify the public choice constraint typically associated with fringe benefit plans, leaving only the "trickle up" effect as a limitation on their use. Moreover, section 125's generous nondiscrimination rule seemed to relax even that constraint. As originally enacted, except with respect to certain types of medical benefits which were subject to a more stringent test,¹⁹² section 125 required only that lower paid employees eligible for benefits under cafeteria plans receive a similar proportion of their income in the form of tax-free benefits as did the suspect group of highly compensated employees.¹⁹³ This was a more generous standard than the "equal amounts" benefits test applicable to many benefits available under fringe benefit plans.¹⁹⁴ As explained below, however, the addition of section 125 did not have the catastrophic consequences on the public choice constraint this brief description of it might suggest, though it certainly had more of an effect on the availability of fringe benefits than Congress foresaw at the time.

Many members of Congress were unaware of the effect cafeteria plans would have on the availability of tax-favored fringe benefits when the enabling legislation was passed. The measure received relatively little comment at the time and there is little direct evi-

would have to make] additional amendments not intended," and that "such rules would . . . add[] complexity not contemplated by Congress." STAFF OF THE JOINT COMMITTEE ON TAXATION, DESCRIPTION OF TECHNICAL CORRECTIONS BILL OF 1987 145 (1987). See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1011B (a)(12), 102 Stat. 3342, 3485 (codified at I.R.C. § 125(c)(1)(B)).

¹⁹⁰ The permissible components of this "menu" have varied over time. See *infra* text accompanying note 214.

¹⁹¹ Of course, benefit distributions must meet any applicable nondiscrimination standards.

¹⁹² See I.R.C. § 125(g)(2) (providing that a health benefits plan is nondiscriminatory if contributions on behalf of all participants include an amount which either equals 100% of the cost of the health coverage of the majority of highly compensated participants similarly situated or equals or exceeds 75% of the cost of the health benefit coverage of similarly situated plan participants having the highest cost health benefit coverage under the plan, and contributions or benefits other than health benefits bear a uniform relationship to compensation). But see Fox & Schaffer, *supra* note 22, at 625-27 (discussing "ambiguity" of section 125(g)(2)'s nondiscrimination rule); Gordon, *Adventures in Obscurity: Section 125(g)(2) of the Code*, 34-9 TAX NOTES 919 (1987) (arguing the effect of section 125(g)(2) is to loosen the generally applicable nondiscrimination rules in the context of cafeteria plans providing health benefits).

¹⁹³ See S. REP. NO. 1263, *supra* note 22. See also I.R.C. § 125(g)(2)(B) (1982).

¹⁹⁴ See Wiedenbeck, *supra* note 60, at 229.

dence of Congress's motivations for passing it.¹⁹⁵ No one seems to have considered the effect cafeteria plans could have on the total amount of nontaxable benefits provided by employers. Indeed, the revenue estimate accompanying the bill projected that granting tax-favored status to benefits provided under cafeteria plans would have no revenue effect.¹⁹⁶

In part, Congress's lack of concern may reflect the fact that the cafeteria plan rules were not as generous as the language of section 125 indicated. For example, section 125's liberal nondiscrimination rule applied in addition to, rather than in lieu of, the nondiscrimination standards already applicable to particular benefits offered under the plan.¹⁹⁷ Thus, for example, if one of the benefits available under a cafeteria plan were group legal services, both the group of employees electing such benefits and the amount of legal services actually provided under the plan had to meet the nondiscrimination standards imposed by section 120 and section 125. Because the nondiscrimination rule contained in section 120 required that low paid employees receive "benefits" approximately equal in amount to those provided highly compensated employees,¹⁹⁸ the existence of the cafeteria plan's liberal rule was essentially irrelevant for recipients and purveyors of those benefits. Compliance with section 125 alone would not make group legal services benefits distributed under a fringe benefits plan excludable from income. The real

¹⁹⁵ S. REP. NO. 1263, *supra* note 22, at 74-76. Later commentators ascribe its success to a variety of motives. One such motive was the desire to impose a nondiscrimination requirement on existing but as yet unregulated forms of welfare benefit plans. See *Basssey, supra* note 188, at 336-37; Fox & Schaffer, *supra* note 22, at 626. See also *Revenue Act of 1978: Hearings on H.R. 13511 Before the Senate Comm. on Finance, 95th Cong., 2d Sess. 1147-49 (1978)* (statement of Converse Murdock, Esq. that many small businesses already had "cafeteria plans" without realizing it and operated them in a way that probably violated proposed nondiscrimination rules). Another alleged motivation was the control of health care costs. By offering employees the opportunity to reclaim any savings in health insurance premiums in the form of cash or more desirable benefits, Congress believed that cafeteria plans would provide an inducement for employees with expensive health insurance benefits to switch to less comprehensive coverage. Such a switch would, in turn, reduce total health expenditures and, in the long run, health care costs. See *Department of Health and Human Services, A Study of Cafeteria Plans and Flexible Spending Accounts, reprinted in 540 Pens. Plan Guide (CCH), at 21 & nn.18-19, 39-40 (Aug. 8, 1985)* [hereinafter *Cafeteria Plan Study*].

¹⁹⁶ See H.R. REP. NO. 1445, 95th Cong., 2d Sess. 64 (1978). For a complete accounting of Treasury's and Congress's input on this issue, see Fox & Schaffer, *supra* note 22, at 619-34.

¹⁹⁷ See H.R. CONF. REP. NO. 1800, 95th Cong., 2d Sess. 254 (1978) ("if a self-insured medical reimbursement plan is included in a 'cafeteria plan', the medical reimbursement plan rules would determine the status of a benefit as a taxable or nontaxable fringe benefit"). Treasury generalized this to cover all benefits provided under a cafeteria plan in its 1984 proposed regulations. See Prop. Treas. Reg. § 1.125-1, Q & A - 16, 49 Fed. Reg. 19,321 (1984).

¹⁹⁸ See *supra* text accompanying notes 112-21.

impact of the rule fell on benefits not already subject to any nondiscrimination rule, and, for these, it imposed a restriction where there had been none before.

Subjecting benefits distributed under cafeteria plans to the pre-existing nondiscrimination tests did more than rejuvenate the "trickle-up effect." It also ensured that the public choice dilemma would continue to exist at a reduced level of significance. Although employees could elect whatever benefits were available under the plan, benefits provided to highly paid employees were excludable from income only if a sufficient percentage of nonhighly paid employees elected similar amounts of the same benefits.¹⁹⁹ Benefits provided to highly compensated employees would be taxed even if all employees chose the same number of dollars of nontaxable benefits, if the nonhighly paid employees preferred a different mix of benefits.²⁰⁰ Thus, complete nontaxability depended on whether nonhighly paid employees desired the same benefits as their highly compensated counterparts. It may be more likely that a consensus as to the amount and type of desirable benefits exists in a narrow cross-section of a heterogeneous group of employees than for the entire employee group, but it also is possible that employee preferences as to the desirability of particular benefits will be stratified according to income level. If the latter is the case, the overlapping of the general cafeteria plan and benefit-specific nondiscrimination rules effectively dissipated the advantage of having a cafeteria plan and reimposed the public choice dilemma.

The limiting effect of this overlapping of nondiscrimination rules, though, was not enough to prevent cafeteria plans from having a seriously adverse effect on the federal budget. Commentators soon realized that widespread use of cafeteria plans could lead to massive revenue losses.²⁰¹ In part, this was because plans partially ameliorated the public choice dilemma. Primarily, however, it was because the use of salary reduction agreements to fund cafeteria plans, as apparently sanctioned by Congress, made possible the de-

¹⁹⁹ See Wiedenbeck, *supra* note 60, at 243. Merely providing an opportunity to participate in a plan offering benefits through a cafeteria plan is not sufficient to meet most eligibility requirements, let alone benefit level tests. To "benefit" from a plan, an employee must "participate" in it. See *supra* notes 69-75 and accompanying text. To participate in a benefit plan made available under a cafeteria plan, an employee must *elect* to participate—an act which requires forgoing the opportunity to obtain another benefit or cash. Employees who are unlikely to utilize such a plan would presumably hesitate to make such a sacrifice.

²⁰⁰ See Wiedenbeck, *supra* note 60, at 243.

²⁰¹ See *Chapoton Testimony*, *supra* note 151, at 1195; *Cafeteria Plan Study*, *supra* note 195, at i (revenue losses will grow to \$12 billion per year in 1983 dollars from health spending component alone); Thompson, *Flexible Compensation Plans and the Small Employer*, 83-7 TAX MGMT. COMP. PLAN. J. 24, 25 (1983).

velopment of more attractive forms of traditional fringe benefits.²⁰²

Beginning in 1982, the type of plan that came to be known as the "flexible spending account" plan appeared.²⁰³ These plans allowed employees to put pre-tax dollars aside in accounts from which medical expenses, child care expenses, or legal expenses could be paid. At the end of each year, any unused amounts left in the accounts were distributed in the form of cash to the employees or were rolled over to their following year's fringe benefit accounts.²⁰⁴ These plans quickly evolved into "zebras," (zero balance account plans) under which employers simply reduced employees' taxable income on the basis of evidence of qualifying expenditures without the bookkeeping formality of an individual account for each employee.²⁰⁵ The employer then issued separate checks to pay (or reimburse the employee for paying) the qualified expenditures. By allowing employees to self-insure against incurring the tax-favored categories of expenditures, these plans guaranteed that employees would receive the monies committed to them either in the form of cash salary or as payment of expenses actually incurred. As a result, these plans were profitable even for those individuals who believed their risk of incurring a tax-favored liability was low.²⁰⁶ The plans provided all employees with a costless means of obtaining the maximum government subsidy available for each category of expenditures. Even lower paid employees benefited. When guaranteed either benefits or a return of their contribution, lower paid employees who were otherwise unwilling to insure against remote contingencies could be enticed to participate in fringe benefit plans. Of

²⁰² To some extent, the result of combining the salary reduction and cafeteria plan mechanisms is a further loosening of the public choice constraint; such plans allow employees individually to determine the amount of their income payable in the form of fringe benefits, as well as the types of benefits received. Of course, employers can achieve the same result by offering a very rich cafeteria plan with a cash option. Plans which offer a choice among nontaxable benefits but not among such benefits and cash avoid only the latter source of the public choice constraint. This may be one reason Congress and Treasury were willing to exclude non-cash-option plans from the purview of section 125, *see supra* note 189, and allow such plans to offer some benefits which cannot be included in a cafeteria plan's menu. *See* Priv. Ltr. Rul. 87-28-067 (1987) (approving plan offering educational assistance as an option). However, the use of the salary reduction device had an effect independent of the relaxation of the public choice constraint. It allowed employees to elect benefits with retrospective knowledge; that is, instead of trading cash for insurance against particular potential expenditures, employees could trade cash salary for payment of liabilities actually incurred. The latter is a more attractive option for many. *See* discussion *infra* text accompanying notes 203-06.

²⁰³ *Cafeteria Plan Study*, *supra* note 195, at 1.

²⁰⁴ *Id.* at A1-4.

²⁰⁵ *Id.*

²⁰⁶ If expenses were incurred, such individuals would be entitled to pay them out of pre-tax dollars. If, as expected, no such expenses materialized, the individuals would receive the balance left in their account in cash and be no worse off as a result of their participation.

course, the more lower level participation existed, the more benefits upper income employees could receive without violating the nondiscrimination rules. Under zebra plans, although nondiscrimination rules would continue to have bite, it would be at a higher level of fringe benefit expenditure. And the higher the level of fringe benefit expenditures, the greater the loss in tax revenue.

Because only the government (and not employees) could lose under these plans, the plans received instant notoriety.²⁰⁷ Afraid of huge revenue losses, in 1984 Treasury hurriedly issued a portion of its long delayed²⁰⁸ regulations for the implementation of section 125.²⁰⁹ Utilizing questionable interpretations of traditional tax law principles and the legislative history of section 125,²¹⁰ these regulations concluded that neither zebras nor flexible spending account plans qualified as cafeteria plans eligible for the benefits of section 125.²¹¹ The regulations forced cafeteria plans to operate under a "use it or lose it" principle, which made participation much less attractive for employees who did not perceive themselves as likely to

²⁰⁷ Several articles extolling the virtues of such plans appeared in both trade and popular publications. See, e.g., Werther, *Implementing Flexible Fringe Benefits Through Variable Incentive Plans*, 33 C.L.U. J. 37, 39 (1979) ("flexible benefit plans do offer a solution to the most serious flaws in traditional approaches"); *Companies Offer Benefits Cafeteria Style*, Bus. Wk., Nov. 13, 1978, at 116. However, commentators divide on the question of whether this publicity triggered the adoption of many plans. *Compare Cafeteria Plan Study*, *supra* note 195, at A1-4 ("FSAs were quickly adopted by many employers") and Bassey, *supra* note 188, at 336 ("cafeteria plans . . . have perhaps been the most frequently used fringe benefit of all in recent years") with Thompson, *supra* note 201, at 24 ("only about three dozen companies currently sponsor flexible programs"); Burgess, *Cafeteria Plans and Alternative Methods for Providing Taxable Benefits to Employees (Part 1)*, 13 COMP. PLAN. J. 166, 167 (1985) ("increased use of cafeteria plans following enactment of § 125 has not been widespread") and EMPLOYEE BENEFITS IN MEDIUM AND SMALL FIRMS, *supra* note 147, at 89 ("Five percent of employees in medium and large firms were offered flexible benefits plans, reimbursement accounts, or both.").

²⁰⁸ Commentators recognized the need for immediate guidance on many aspects of cafeteria plan formation as early as 1979. See, e.g., Bassey, *supra* note 188, at 338-39; Fox & Schaffer, *supra* note 22, at 635. The absence of such guidance made these plans too risky to be widely adopted. Bassey, *supra* note 188, at 338-39 (absence of rulings and regulations "[a]s a practical matter . . . frustrate[d] Congressional intent to make the benefits of the cafeteria plan available to a wide cross-section of employees"); Fox & Schaffer, *supra* note 22, at 636 ("In the absence of regulations, cafeteria plans spread slowly.").

²⁰⁹ Notice of Proposed Rulemaking, *Tax Treatment of Cafeteria Plans*, 49 Fed. Reg. 19,329, Q & A - 17-18 (May 7, 1984) [hereinafter Notice of Proposed Rulemaking]. The regulations were preceded by a news release summarizing their contents. I.R.S. News Release IR-84-22 (Feb. 10, 1984).

²¹⁰ See, e.g., Chip, *New Cafeteria Plan Regulations Contain Implications for Other Employee Plans*, 63 J. TAX'N 72 (1985) ("rule in Proposed Regulations against guaranteed amounts appears to be a newly discovered general principle of tax law"); Irish, *supra* note 188, at 1133-39 ("[T]he deferred compensation position implicit in the proposed regulations defies common sense, established distinctions, and settled case law.").

²¹¹ See Notice of Proposed Rulemaking, *supra* note 209; *Cafeteria Plan Study*, *supra* note 195, at A1-4.

incur health care and other expenses.²¹²

In the Deficit Reduction Act of 1984, Congress implicitly endorsed Treasury's position on the "use it or lose it" principle²¹³ and cut back on the types of nontaxable benefits in a cafeteria plan's menu. After January 1, 1985, cafeteria plans could offer only cash and "statutory fringe benefits," defined as "any benefit which . . . is not includible in the gross income of the employee by reason of an express provision of this chapter (other than section 117, 124, 127, or 132)."²¹⁴ The effect of this change is to reimpose the public choice constraint on the provision of the excluded benefits. Together, these revisions made cafeteria plans less comprehensive, less attractive mechanisms for delivery of fringe benefits.

3. *Reality Reformed: Reworking the Rules*

Congress revisited the fringe benefit area yet again in 1986. The statutory changes enacted in that round of tax reform had conflicting effects on the continuation of the public choice constraint. Some of the changes relaxed the constraint by increasing the attractiveness of cafeteria plans while others could only have the opposite effect.

The first and most obvious of the changes is the joint benefits test, made possible by the interaction of subsections (i)(2), (j)(7), and (g)(4) of new section 89. Subsection 89(i)(2) allows, but does not require, employers to treat qualified group legal services plans, educational assistance programs, and dependent care assistance plans as "statutory fringe benefit plans."²¹⁵ Once an employer elects to treat such a plan as a "statutory fringe benefit plan," section 89(j)(7) tests for discrimination in accordance with section 89's rules *rather than* the otherwise applicable standards.²¹⁶ Finally, section 89(g)(4) allows employers to treat all statutory fringe benefit

²¹² Such employees would lose any amounts left in their accounts at the end of the year. Thus, overestimating expenses would inflict a real cost on the participating employee.

²¹³ In section 531(b)(5) of the 1984 Act, Congress included transition rules for the application of the Proposed Regulations to preexisting cafeteria plans. See Tax Reform Act of 1984, Pub. L. No. 98-369, § 531(b)(5), 98 Stat. 494, 883. By doing so, it implicitly endorsed the substantive validity of the regulations. Irish, *supra* note 188, at 1132.

²¹⁴ I.R.C. § 125(e)(1). The benefits excepted by the parenthetical include tuition remission, educational assistance, vanpooling, and the miscellaneous benefits legitimized by section 132, leaving only health insurance, life insurance, disability benefits, legal insurance, dependent care, and certain qualified cash or deferred pension arrangements within the definition of "statutory fringe benefits." Some of the benefits omitted from the cafeteria plan menu, like educational assistance, can be provided under flexible plans without a cash option. See *supra* note 202.

²¹⁵ I.R.C. § 89(i)(2).

²¹⁶ I.R.C. § 89(j)(7).

plans except health plans²¹⁷ as plans of the same type for purposes of applying the benefits test of section 89(e). This test, as the tenacious reader may recall, requires that nonhighly compensated employees receive, on average, employer-provided benefits valued at three-quarters of the average employer provided benefits distributed to highly compensated employees under plans of the same type.

Allowing combinations of different types of plans for purposes of this test makes variations in the selection of benefits irrelevant. For example, if an employer elects to treat both dependent care assistance and legal insurance as statutory fringe benefit plans, it can meet the benefits test if all nonhighly compensated employees choose to receive benefits in the form of dependent care assistance while highly compensated employees choose an equivalent amount of legal services. Both types of plans have to be open to a cross-section of employees,²¹⁸ but neither actually has to be used by a cross-section of employees. As long as the nonhighly compensated employees find one of the plans attractive enough to participate to the extent required,²¹⁹ the plan meets the discrimination standards. No public choice constraint independent of the trickle-up restraint necessarily restricts the delivery of "statutory fringe benefits."

Liberalization of the benefits test appears to be a stunning concession by Congress. Further examination reveals, however, that its impact (and hence its revenue implications) will be far less significant than the statutory language suggests. This results largely from the type of benefits eligible as "statutory fringe benefits." Two of the three eligible fringe benefits, group legal services plans and educational assistance programs, were supposed to lose their tax-favored status before section 89 became effective. Temporary exclusions for these benefits were supposed to last only until December 31, 1987, the effective date of section 89.²²⁰ Congress may,

217 *But see supra* note 139.

218 Plans must satisfy both the eligibility and benefits level tests. I.R.C. § 89(c).

219 That is, enough to meet the three-quarters ratio required by section 89(e).

220 Congress amended section 120(e) to provide, "this section . . . shall not apply to taxable years ending after December 31, 1987," Tax Reform Act of 1986, Pub. L. No. 99-514, § 1162(b), 100 Stat. 2085, 2549, while section 127(d) was amended to provide that "this section shall not apply to taxable years beginning after December 31, 1987." *Id.* § 1162(a)(1). For a discussion of the effective date of section 89, *see supra* note 63. Indeed, the reason Congress gave for omitting group legal plans and educational plans from mandatory coverage by section 89 was "that these types of plans generally are scheduled to expire prior to the effective date of the new nondiscrimination rules." 1986 GENERAL EXPLANATION, *supra* note 64, at 809. *See* H.R. CONF. REP. NO. 841, *supra* note 81, at pt. 2, at 508. Congress extended the termination date for group legal services plans in the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 4001, 102 Stat. 3342, but only for one year. *Id.*

of course, extend the tax-free status of these benefits,²²¹ but such extensions are not guaranteed. Thus, it is uncertain whether either type of benefit will ever be part of section 89(h) packages. Moreover, even if Congress again extends the expiration date, it is unlikely to further liberalize the exclusion by making educational assistance available through a cafeteria plan. The inability to distribute such benefits through a cafeteria plan makes avoiding the public choice constraint more difficult, because employers will have difficulty identifying in advance those employees whose cash salaries should be bargained down to pay for the plan.²²² Finally, the 1986 Tax Act even made dependent care assistance less valuable than it had been. The Act imposes a more restrictive cap on the quantity of excludable benefits that may be distributed under a plan. Prior to 1987, an employee could exclude dependent care assistance up to the lower-earning spouse's income; now the exclusion is limited to the lower of that amount or \$5000.²²³ In sum, Congress tempered its generosity considerably in the fine print.

Broadening the list of excludable employees for purposes of applying the benefits tests to health plans and dependent care assistance may be the provision of the 1986 Tax Act that most effectively reduces the public choice constraint. Under this provision, an employer may ignore employees (together with their families) who are covered by "a health plan providing core benefits maintained by another employer,"²²⁴ when determining whether a health plan distributes benefits in a nondiscriminatory fashion. Similarly, when providing family coverage, an employer has the option of separately running the benefits test for the expense of providing family coverage and only including employees with families in its calculations.²²⁵ Finally, when running a benefits test on dependent care assistance programs²²⁶ funded through salary reduction agreements, employers may exclude employees earning less than \$25,000.²²⁷ In each

²²¹ See *supra* note 220 (extension of favorable tax treatment of group legal services plans). Tax Reform Act of 1986, Pub. L. No. 99-514, § 1162(b), 100 Stat. 2085, 2549 (1986).

²²² But see *supra* note 202.

²²³ I.R.C. § 129(a)(2).

²²⁴ I.R.C. § 89(g)(2)(A)(i).

²²⁵ I.R.C. § 89(g)(2)(A)(ii).

²²⁶ See I.R.C. § 129(d)(7)(A) (requiring average benefit provided nonhighly compensated employees under plan to equal 55% of average benefits provided highly compensated employees).

²²⁷ I.R.C. § 129(d)(8)(B). At this income level, the child care credit available under section 21 is more valuable to a taxpayer than is the exclusion. Taxpayers (if well-informed) will, therefore, always opt to pay their child care expenses themselves and claim the credit rather than avail themselves of the salary reduction possibility. See Sheppard, *Ways and Means Aide Discusses Tax Bill's Health Plan Nondiscrimination Rules*, 32-13 TAX NOTES 1219, 1221 (1986).

case, the excluded employees are among the least likely employees to take advantage of plan benefits because they have no use for them. Absent the exclusions, plans would likely fail the benefits test if a disproportionate number of such employees fell within the nonhighly compensated group and the employees had the option of cash rather than the benefit.

For example, consider an employer who offers to provide family coverage worth \$2000 to all ten of its employees, six of whom (including the employer's two highly compensated employees) actually have families. Assuming each of the employees with families elects to take advantage of the offer, absent the exclusion, the average employer-provided benefit for highly compensated employees would be \$2000 ($2000 \times 2/2$) while the average employer-provided benefit for less highly compensated employees would be \$1000 ($2000 \times 4/8$)—well under 75% of highly compensated employees' benefits. As a result, \$1000 of the health insurance provided upper income employees would be included in their income. By contrast, once single employees are excluded, the average employer-provided benefit is the same for both highly and nonhighly compensated employees and the highly compensated employees can exclude all \$2000 of insurance from their income. While these exclusions do not necessarily cover all the employees who would not want to participate in a health or dependent care assistance plan,²²⁸ they diminish the impact of the public choice constraint by compensating for the disproportionate distribution of some significant causes of differentials in utilization patterns.

These liberalizations were not the only changes the 1986 Tax Act made in the fringe benefit rules. Congress also prospectively eliminated two types of previously available fringe benefits and imposed a cap on one other.²²⁹ These changes, unlike the reductions in the public choice constraint, will raise revenue. Perhaps Congress, after silent examination of revenue and equity concerns, has decided to change its approach towards the regulation of fringe benefits; instead of relying on the public choice constraint, it may be moving towards more direct limitation of the amount and types of excludable benefits coupled with a more effective trickle-up constraint. This sacrifices approximately the same amount of revenue but distributes the largesse to a larger, more diverse group of taxpayers than before. If so, we can expect to see future changes along

²²⁸ For purposes of running the benefits test on dependent care assistance programs, no exclusion is provided for employees without dependents (as it is for the provision of family coverage provided under health plans). See I.R.C. § 89(g)(2)(A). Perhaps the reduction in the required ratio (from 75% to 55%) is intended to compensate for this seemingly unfair discrepancy.

²²⁹ See *supra* text accompanying notes 220-23.

the lines of the 1986 Tax Act. As I discuss in Part IV, such a decision may well be justifiable on social policy grounds.

The appearance of the public choice constraint in one area of the Code is interesting but not necessarily significant. Especially in light of the trend towards minimizing its impact in the fringe benefit area, one could even argue that the employment of the public choice constraint in those rules was an accident—the inadvertent result of a complicated solution to a knotty substantive and drafting problem. However, its appearance in another, unrelated area of the Code, the area governing the taxation of international transactions discussed in part III of this article, suggests that the public choice constraint is more than that. It suggests, instead, that the constraint may provide a powerful tool for explaining and analyzing the success of provisions in the Code governing the tax treatment of group activities, such as partnerships, corporations, and associations.

III

INTERNATIONAL TAX

The fringe benefit rules are not the only set of rules in the Code which utilize the public choice constraint to limit tax avoidance. The constraint also appears in one of the most technical and arcane areas of international tax law, the Subpart F rules.²³⁰ Specifically, it appears in the definition of specially disfavored “controlled foreign corporations.”²³¹ To understand the role of the public choice constraint in this context, one must first consider Subpart F’s role in the United States scheme for taxation of international transactions.

A. Statutory Overview

With very few exceptions, the United States does not levy an income tax directly on the foreign-sourced income²³² of foreign corporations,²³³ even when those corporations are wholly or partially owned by United States residents, citizens, or corporations.²³⁴

²³⁰ Sections 951 through 964 of the Internal Revenue Code are known as the “Subpart F” provisions. Technically they comprise Subpart F of Part III of Subchapter N of the Internal Revenue Code. *See* I.R.C. §§ 951-64.

²³¹ *See* I.R.C. § 957(a) (defining “controlled foreign corporation”).

²³² Sections 862 through 863 of the Internal Revenue Code provide rules for determining whether income is foreign-sourced or sourced within the United States. *See* I.R.C. §§ 861-63. The highly particularized rules for specific transactions, generally attribute income to the locality where the bulk of the income producing activities are performed.

²³³ A foreign corporation is any corporation other than one “created or organized in the United States or under the laws of the United States or of any State.” I.R.C. §§ 7701(a)(4)-(5).

²³⁴ *See* H.R. REP. NO. 1447, 87th Cong., 2d Sess. 57 (1962); W. GIFFORD & E. OWENS, INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION: CASES AND MATERIALS 6-7

Rather, foreign-sourced income is generally taxable only after its distribution to domestic (United States) taxpayers as dividends or gains from the disposition of the foreign corporation's shares. The shareholder then pays federal income tax on those dividend or gain amounts in accordance with normal tax rules.²³⁵

This taxing regime creates tax advantages for United States taxpayers willing to invest in foreign jurisdictions with lower income taxes. By engaging in foreign activities through a foreign corporation organized and operated in a low tax jurisdiction,²³⁶ investors can defer payment of a portion—and often a very large portion—of their tax burden. Investors in domestic corporations do not have this opportunity to defer taxation; their corporation's income is taxed as it is earned.²³⁷ Because deferral is the economic equivalent of a reduction in the overall tax rate,²³⁸ this tax regime lowers "foreign" (United States investors investing through foreign corporations) investors' tax burden below that of wholly domestic investors,²³⁹ and leaves them with higher after-tax profits from the

(1982); R. GORDON, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS—AN OVERVIEW 50 (1981); Kingson, *The Coherence of International Taxation*, 81 Colum. L. Rev. 1151, 1183 (1981). The United States taxes foreign corporations only on income which is "received from sources within the United States," I.R.C. § 881(a), or "which is effectively connected with the conduct of a trade or business in the United States." I.R.C. § 882(a)(1). Most "effectively connected income" is "income from sources within the United States." See I.R.C. § 864(c).

²³⁵ See H.R. REP. NO. 1447, *supra* note 234, at 57; W. GIFFORD & E. OWENS, *supra* note 234, at 7. The taxpayer may, however, be entitled to take a credit against his United States income tax liability for foreign income taxes paid by the foreign corporation with respect to the income so distributed, as well as for the taxpayer's foreign income taxes resulting from the distribution. See I.R.C. §§ 901-02. For a comprehensive explanation of this elaborate tax credit scheme, see, e.g., P. MCDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 79-102 (1981); 2 R. RHOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 5 (1988); AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT—INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 307-421 (1987).

²³⁶ A "low tax jurisdiction" is any jurisdiction that exacts less income tax than does the United States.

²³⁷ I.R.C. § 11.

²³⁸ See AMERICAN LAW INSTITUTE, *supra* note 235, at 172; W. GIFFORD & E. OWENS, *supra* note 234, at 129-30; Kingson, *supra* note 234, at 1183.

²³⁹ Aside from deferral, the total tax burden on United States investments abroad is equivalent to the burden on domestic investments. See H.R. REP. NO. 1447, *supra* note 234, at 57. This equivalence is "approximate." See 2 R. RHOADES & M. LANGER, *supra* note 235, § 5.01[1]. In addition to deficiencies in the tax credit computation formula, which in some cases keep the credit from exactly offsetting the foreign tax burden, differences in source, exclusion, or deduction rules may tax certain items of income twice. See 3 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 69-11 (1981); Kingson, *supra* note 234 at 1185-87. Moreover, individual United States taxpayers are not allowed a tax credit for foreign taxes paid by a foreign corporation they have invested in. See I.R.C. § 902. Thus, if the corporation pays foreign taxes, the taxpayer's total tax burden (foreign and domestic) will exceed that imposed on United States citizens making domestic, unincorporated investments. As compared to making domestic incorpo-

same investment than domestic investors.

Proponents of this "deferral" tax advantage contend that it not only encourages United States citizens to invest overseas, but also that it is necessary to preserve the competitiveness of domestic companies operating abroad. Any businesses that Americans can successfully operate in low tax jurisdictions, it is argued, foreign investors can carry on equally well. If the United States revoked its investors' favorable tax treatment, the argument continues, foreign investors would use their now unique tax advantage to overwhelm their American competitors, wherever located. In short, far from encouraging United States investors to repatriate their overseas operations to the United States, eliminating their tax advantage would cause United States investors to lose their overseas operations to foreign competitors without any corresponding increase in American investment. The end result would be an even larger decline in American jobs, exports, and tax revenues than results from allowing deferral to continue.²⁴⁰

Though generally convinced by this argument,²⁴¹ Congress eventually recognized that a deferral regime may permit a number of abuses. First, some foreign corporations held passive investments, rather than engaging in active trades or businesses. Passive corporations did not face the competitive pressures Congress was concerned about.²⁴² Their existence was also unlikely to spur

rated investments, however, individual taxpayers investing abroad through lightly taxed foreign corporations come out ahead because the United States does not force payment of the differential between the foreign and United States corporate income tax. See 3 B. BITTKER, *supra* at 69-19. Finally, the equivalency breaks down altogether when the foreign corporation pays higher taxes abroad than in the United States; then the tax burden approximates the higher of the two national rates. R. RHOADES & M. LANGER, *supra* note 235.

²⁴⁰ See, e.g., HOUSE COMM. ON WAYS AND MEANS, 95TH CONG., 1ST SESS., RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME 48-51 (Comm. Print 1977) [hereinafter TASK FORCE REPORT]; H.R. REP. NO. 1447, *supra* note 234, at 57-58; AMERICAN LAW INSTITUTE, *supra* note 235, at 173.

²⁴¹ Congress has on several occasions considered legislation that would completely end deferral but has always rejected such proposals because of "the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries." H.R. REP. NO. 1447, *supra* note 234, at 62. This report stated:

Your committee's bill does not go as far as the President [sic] recommendations [to completely eliminate tax deferral because] . . . to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.

Id. at 57-58. See, e.g., TASK FORCE REPORT, *supra* note 240, at 59 (concluding, after discussion of merits of various proposals to restrict or end deferral, "not to make any recommendations to change the law").

²⁴² See H.R. REP. NO. 1447, *supra* note 234, at 62.

American exports.²⁴³ Allowing them favorable tax treatment, therefore seemed both futile (in that it served no apparent purpose) and dangerous to the federal fisc.²⁴⁴ Second, investors sometimes even misused foreign corporations engaged (or apparently engaged) in overseas business operations. Some employed schemes to divert corporate income corporations earned in the United States or another high tax jurisdiction to related foreign corporations in low tax jurisdictions "by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices."²⁴⁵ Such investors achieved the advantages of deferral for those profits, and gained a competitive advantage over domestic competitors who

²⁴³ Various witnesses testified that American companies operating overseas spurred United States exports because the companies were more likely than foreign owned enterprises to purchase United States components and equipment. *See id.* at 57. Passive investment companies, by contrast, do not purchase components or equipment.

²⁴⁴ Because the cost of establishing and running a foreign passive investment corporation was fairly low, there was potential for widespread avoidance of all United States taxation of passive income on capital investment. Theoretically, almost all owners willing to accumulate rather than immediately spend such income could have postponed (possibly forever) United States income taxation merely by holding their investments—even some of their domestic investments—in foreign corporations. Congress had earlier addressed the specter of widespread avoidance by imposing a penalty tax on "foreign personal holding companies" owned by a small number of United States individuals. *See* I.R.C. §§ 551-58. *See generally* H.R. Doc. No. 337, 75th Cong., 1st Sess. 16-17 (1937); Paul, *The Background of the Revenue Act of 1937*, 5 U. CHI. L. REV. 41, 49-52 (1937). Those provisions had no effect, however, on foreign corporations owned by widely held domestic corporations or by more than five individuals. *See* AMERICAN LAW INSTITUTE, *supra* note 235, at 190 (criticizing narrow reach of foreign personal holding company provisions).

²⁴⁵ *Hearing on the Tax Recommendations of the President Contained in his Message Transmitted to Congress Before the Comm. on Ways and Means, April 20, 1961*, 87th Cong., 1st Sess. 8 (1961) (excerpt from President Kennedy's State of the Union Message). *See also* H.R. REP. No. 1447, *supra* note 234, at 58; R. GORDON, *supra* note 234, at 50-51, 62-63 (describing various methods of effecting diversions). The Internal Revenue Service had the power to police such abuses. As early as 1921, Congress gave the Commissioner the authority to "consolidate accounts for related trades or businesses" for the purpose of "making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses." Revenue Act of 1921, § 240(d), *reprinted in* R. GORDON, *supra* note 234, at 52. This statutory language empowers the Service to reallocate income that has been improperly assigned to an entity established in a low tax jurisdiction to a related United States taxpayer and subject it to current taxation in the United States. In 1928, the predecessor of section 482 replaced section 240(d) and provided for the allocation of gross income or deductions among related entities. Section 482 remains "one of the most important anti-avoidance provisions in the law." *Id.* at 52. Nonetheless, the expense and time required to win an adjustment pursuant to this provision keep section 482 from being as effective as its drafters hoped it would be. This expense is in no small part due to the inordinately complicated, and in some degree unworkable, regulations promulgated under section 482, *see id.* at 129-30; Cohen & Hankin, *A Decade of DISC: Genesis and Analysis*, 2 VA. TAX REV. 7, 17 (1982) ("implementation of section 482 has been inconsistent and confusing"); Fuller, *Problems in Applying the § 482 Intercompany Pricing Regs. Accentuated by DuPont Case*, 52 J. TAX'N 10 (1980).

were unable or unwilling to participate in such schemes.²⁴⁶ Finally, Congress believed many taxpayers deferred tax for too long, or avoided taxation completely by repatriating their foreign profits in forms which, unlike dividends, did not trigger the imposition of a catch-up United States income tax.²⁴⁷ These taxpayers received more of a tax benefit than necessary to meet foreign competition, while simultaneously placing domestic competitors lacking such tax benefits (and perhaps paying taxes at a higher rate to compensate the federal fisc for the associated revenue loss) at a comparative disadvantage.

Concern over these abuses led to the enactment, in 1962, of "Subpart F"; a set of tax rules in sections 951 through 964 of the Code. These rules withdraw the deferral privilege from income generated in a narrowly defined set of transactions.

The operative provision in Subpart F, section 951, requires "United States shareholders" of "controlled foreign corporations" to include their pro rata share of the corporation's "Subpart F income" and "increases in profits invested in the United States" in their own income in the year earned or invested by the foreign corporation.²⁴⁸ In most cases, the effect of including these items in income is that the shareholder pays a federal income tax approximately equal to the tax it would have paid had it, rather than the foreign entity, earned those income items.²⁴⁹

Subpart F income, as originally defined in section 952 of the Code, included income derived from the insurance of United States risks and "base company income."²⁵⁰ The latter is a technical term encompassing foreign personal holding company income (essentially passive income), sales income from property purchased from or sold to a related party whenever the property is manufactured

²⁴⁶ See *supra* text accompanying note 239.

²⁴⁷ H.R. REP. NO. 1447, *supra* note 234, at 58.

²⁴⁸ I.R.C. § 951(a)(1).

²⁴⁹ Like shareholders receiving dividend distributions from foreign corporations, see *supra* note 235, corporate shareholders receiving "deemed distributions" under Subpart F are entitled to a tax credit for foreign income taxes paid on the deemed distribution. See I.R.C. § 960. Individual shareholders are allowed a choice of tax treatment: they may step forward and pay the entire second tier of the two level tax at the time the deemed distribution is included in their income or they may elect to be treated as a corporate shareholder at that time (i.e., pay the difference between the foreign and United States corporate tax burdens), and pay the (entire) shareholder level tax when profits are actually distributed. See I.R.C. § 962. Both the amount of foreign tax paid and the expected timing of the actual dividend distribution will affect the choice.

²⁵⁰ Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1008 (codified as amended at I.R.C. § 952). See also H.R. CONF. REP. NO. 2508, 87th Cong., 2d Sess. 30 (1962). Congress later added several additional components to the definition of Subpart F income as a means of enforcing several essentially unrelated regulatory schemes. See R. GORDON, *supra* note 234, at 57.

and sold for use, consumption or disposition outside the corporation's country of incorporation, income derived from services performed outside the country of the corporation's incorporation for, on behalf of, or with substantial assistance from a related party, and certain shipping income.²⁵¹ These transactions were singled out because they lack an obvious business connection to the country of incorporation which generated congressional suspicion that the company was "separat[ing] [income] from manufacturing activities of a related corporation merely to obtain a lower rate of tax."²⁵² The involvement of a related party suggested that the companies agreed to overstate sales and service income to achieve this separation.²⁵³ Thus the income was doubly suspicious and disfavored.

Despite the fact that all Subpart F income was equally likely to be generated in pursuance of an illicit²⁵⁴ tax avoidance scheme,

²⁵¹ R. GORDON, *supra* note 234, at 56. See I.R.C. § 954(a).

²⁵² S. REP. NO. 1881, 87th Cong., 2d Sess. 84 (1962). See also S. REP. NO. 313, *supra* note 62, at 363 (reaffirming that "it is generally appropriate to impose current U.S. tax on easily movable income earned through a controlled foreign corporations since there is likely to be limited economic reason for the U.S. person's use of the foreign corporation"). Indeed, prior to the passage of the 1986 Tax Act, income falling within the technical description of base company income could nonetheless be excluded if the taxpayer could prove to the satisfaction of the Secretary that neither the creation, organization or acquisition of the foreign corporation, nor the "effecting of the transaction giving rise to such income . . . has as one of its significant purposes a substantial reduction of income, war profits, or excess profits or similar taxes." I.R.C. § 954(b)(4) (1985) (*amended by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(d), 100 Stat. 2085. Such income is still excludable if the taxpayer can prove it "was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11." I.R.C. § 954(b)(4).

²⁵³ See H.R. REP. NO. 1447, *supra* note 234, at 58. One could accomplish this overstatement in a number of ways. For example, a United States manufacturing company selling goods overseas could form a foreign corporation in a tax haven country to make those sales. The parent could then sell the goods to the subsidiary at a small or zero profit, while the subsidiary would sell them to the ultimate customer at a substantial markup. The profits on sales would escape taxation in the United States and could accumulate free of tax in a tax haven. Of course, some of this "profit on the sale" is really manufacturing profit and should be taxable immediately in the United States. However, unless the United States manufacturer makes similar sales to unrelated parties at higher prices, the Service will have great difficulty justifying a reallocation pursuant to section 482. See R. GORDON, *supra* note 234, at 129.

²⁵⁴ That is, one which the Service could successfully challenge under general tax principles and statutes if it possessed all the relevant information. Obtaining information, especially in the context of international transactions, was and still is quite difficult, expensive and time consuming. See *id.* at 180. Indeed, a major focus of reform efforts in the international tax arena is improving our information gathering abilities. See Crinion, *Information Gathering on Tax Evasion in Tax Haven Countries*, 20 INT'L LAW. 1209, 1224 (1986) (describing recent United States advances in information gathering); Rosen, *An Interview with Outgoing International Tax Counsel Stephen E. Shay: Part One*, 36 TAX NOTES 759, 764 (1987) (identifying as "major accomplishment" of his tenure in office "program to improve international cooperation in the enforcement of tax laws" through promulgation of treaties, tax information exchange agreements, and the multilateral treaty for administrative assistance).

Congress only withdrew the deferral privilege from income which benefited "United States shareholder[s]" of "controlled foreign corporations."²⁵⁵ American entities or individuals owning less than the 10% interest in a foreign corporation required to attain "United States shareholder" status,²⁵⁶ and those owning shares of foreign entities no more than half-owned by United States shareholders²⁵⁷ could continue to enjoy deferral with respect to "their" Subpart F income.²⁵⁸ Congress enacted these limitations because of fairness considerations. The former exception, a "*de minimis* rule," prevents the attribution of undistributed income back to small shareholders whose "influence on the corporation's policy is presumably negligible."²⁵⁹ Although Congress did not explain the second exception, the majority ownership requirement, its widely assumed purpose was to avoid subjecting shareholders who lacked the power to force dividend distributions to cash flow problems by requiring payment of tax on undistributed corporate income or forcing them to assume responsibility for misbehavior they could not control.²⁶⁰ One has to

²⁵⁵ I.R.C. § 951(a)(1). The relevant language has not changed since its original enactment in 1962.

²⁵⁶ See I.R.C. § 951(b).

²⁵⁷ See I.R.C. § 957(a) (1985). For a discussion of changes made in this definition by the 1986 Tax Act, see *infra* notes 320-22 and accompanying text.

²⁵⁸ Unless, of course, the Service mounted a successful challenge to the scheme under section 482, see *supra* note 245, or section 269 (authorizing the Secretary to reject any credit, allowance, or deduction if the principal purpose of acquisition of control of a corporation is evasion or avoidance of federal income tax). Note 245, *supra*, discusses the problems of relying on section 482 to stop tax avoidance schemes; although section 269 is "[a]rguably . . . ideally suited to deal with tax haven transactions," it is not "vigorously" applied in that context. R. GORDON, *supra* note 234, at 133.

²⁵⁹ H.R. REP. NO. 1447, *supra* note 234, at 59.

²⁶⁰ See e.g., R. HELLAWELL & R. PUGH, TAXATION OF TRANSNATIONAL TRANSACTIONS 1987-1988 251-52 (1987) (definition of a "controlled foreign corporation" adopted in 1962 to insure "that a United States taxpayer holding merely a portfolio . . . interest in a foreign corporation would not be subjected to the serious penalty of being taxed in the United States on . . . undistributed earnings . . . even though he lacked the voting power needed to force distribution of those earnings"); L. KRAUSE & K. DAM, FEDERAL TAX TREATMENT OF FOREIGN INCOME 11-12 (1964):

The unfairness argument has more force when the U.S. shareholders have no connection with one another. . . . [O]ne shareholder may be required to pay a tax even though he has neither the funds to pay nor the power to force a dividend. Such a shareholder would be particularly wronged if he acquired his stock before Congress eliminated deferral.

Aland, *The Treasury Report on Tax Havens—A Response*, 59 TAXES 993, 1007 (1981) (decrying as unfair and possibly unconstitutional a suggestion that the more than 50% minimum be dropped); AMERICAN LAW INSTITUTE, *supra* note 235, at 191 ("fundamental questions of fairness arise if Americans are to be taxed on income which they cannot, in combination with other similarly situated American taxpayers, cause to be distributed to them"). Cf. Estate of Nettie S. Miller, 43 T.C. 760, 766-67 (1965) (power to force distribution of dividends required if the foreign personal holding company regime is to accomplish its purpose). See also I.R.C. § 6166 (deferral of estate taxes permissible where estate consists largely of interest in closely held business).

wonder whether Congress was too generous, however, because these limitations provided a roadmap for taxpayers wishing to avoid the strictures of Subpart F while continuing to engage in abusive schemes. Determined taxpayers needed only to join forces with one another to continue business as usual.²⁶¹ For example, 11 taxpayers could join together to form a foreign entity in which each held a 9.09 percent interest. None would be considered U.S. shareholders of this entity, and thus the entity would not be deemed a controlled foreign corporation. Presumably, such cooperative ventures presented an easy escape from Subpart F.

B. The Role of the Public Choice Constraint

In fact, no massive avoidance of the scheme emerged; indeed, the regime has been so successful at accomplishing its intended purpose that it became the model for legislatures of several countries drafting similar legislation.²⁶² In large measure, this success is due to the effects of the public choice constraint. It is not easy for an investor to find other investors with compatible business goals that will remain compatible over time, or to work out mutually acceptable resolutions of those differences that arise. For a business entity to commit itself to an enterprise over which it lacks effective control may entail running business risks that outweigh the tax benefits generated from the arrangement.

Subpart F entities are more vulnerable to such problems than most businesses because their shareholders generally lack a common business (as opposed to tax) agenda. The existence of such conflicts are not fatal to many more common business ventures, such as publicly held corporations. Subpart F corporations are often different from other businesses, however. Rather than generating income through their own efforts and activities, many tax haven entities are essentially collecting agents for income that other, related entities really earn.²⁶³ Thus, rather than trying to work to-

²⁶¹ The exact number of accomplices required depends on their nationality. Assuming the original United States taxpayer owns 50% of the foreign corporation, one foreigner, or some combination of United States nationals and aliens, can own the remaining 50%. One can maintain total United States ownership with one 50% owner and six 8 1/3% owners.

²⁶² See generally R. GORDON, *supra* note 234, at 24-26 (describing similar German, Canadian, French, and Japanese regimes); Tillinghast, *The Contributions of Stanley S. Surrey to the International Aspects of Taxation*, 38 NAT'L TAX J. 267, 269 (1985) (same).

²⁶³ Attributing this income to the collecting agent for federal income tax purposes may be legitimate or illegal, depending upon whether the assignment accords with applicable statutes and regulations. For administrative and other reasons, the Code and regulations allow some income attributions that lack economic integrity to be recognized for tax purposes; in other cases, however, taxpayers are merely taking advantage of the paucity of audit coverage to engage in unlawful pricing schemes. The Internal

gether towards a common business goal (or derive profits from engaging in a common business enterprise), each shareholder's primary concern is protecting its share of the "corporate" income from other shareholders.

Nowhere is the inevitability and insurmountability of this conflict more evident than in the problem of how to invest "corporate" profits. Many of the options available to domestic corporations are not available to Subpart F corporations. Distributing profits to shareholders in the form of dividends would trigger immediate United States taxation.²⁶⁴ Reinvestment in the foreign corporation's business is impractical because the corporation does not have much of a business. (That is, after all, why the income it earns is Subpart F income. If the entity manufactures the goods it sells, for example, the resulting sales income would not be Subpart F income.)²⁶⁵ That leaves open just two possibilities: the foreign entity can invest directly in the shareholders' businesses; or it can make

Revenue Service recently identified the international tax arena as a high priority for future enforcement efforts. See *Tax Reform: Arm's-Length Standard Still Applies Under New "Super Royalty" Rules*, Treasury Official Says, 31 DAILY TAX REP. G-1 (Feb. 18, 1987).

²⁶⁴ The United States parent would, of course, include any foreign dividends in its income for tax purposes and pay tax accordingly. The normal dividends-received-deduction does not apply to dividends received from most foreign corporations, see I.R.C. § 243(a), while the special dividends-received-deduction applicable to dividends received from foreign corporations only allows deductions for dividends attributable to income "effectively connected to the conduct of a trade or business within the United States" (and on which a full United States income tax has already been paid). See I.R.C. § 245(a)(5). Thus, unless the United States parent has sufficient foreign tax credits to offset the additional income tax due (in which case, it would have no need to utilize a decontrolled tax haven entity at all), the receipt of a dividend from a tax haven entity triggers substantial federal tax liability. Paying a dividend to an intermediate foreign corporation controlled by the parent would generally also trigger United States tax liability because the dividend would be Subpart F income (base company foreign personal holding company income) in the hands of the intermediary corporation. See I.R.C. § 954(c)(1)(A). The parent would pay tax accordingly unless less than the lesser of 5% of the intermediary's gross income or \$1,000,000 consisted of foreign base company income. I.R.C. § 954(b)(3). Of course, in that case the taxpayer again had no need to resort to a decontrolled tax haven entity, unless some reason prevented the intermediary from earning the Subpart F income directly. Finally, although prior to the effective date of the 1986 Tax Act the Code excluded from the definition of foreign personal holding company income:

dividends and interest received from a related person which (i) is created or organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created and organized, and (ii) has a substantial part of its assets used in its trade or business located in such same foreign county

I.R.C. § 954(c)(4)(A) (1985), an intermediary corporation receiving a dividend or interest payment from a decontrolled tax haven entity could not take advantage of this exclusion because decontrol prevents the entity from being "related." See I.R.C. § 954(d)(3) (1985).

²⁶⁵ See I.R.C. § 954(d)(1) (defining "foreign base company sales income"). Of course, the corporation must undertake some business activities to prevent the Service from disregarding it as a "sham." See, e.g., *Gregory v. Helvering*, 293 U.S. 465, 469

passive investments such as the purchase of stocks and other securities of unrelated companies.

There are problems with the former option. The other shareholders will also have to invest in the individual shareholder's businesses—businesses in which the other shareholders may have little control, expertise, or interest.²⁶⁶ These investments, unlike a standard portfolio investment (which also may be in businesses over which the shareholder enjoys little control, expertise, or interest), cannot readily be alienated. In short, each stockholder would soon find its profits “hostages” of the other shareholders, a situation intolerable to many potential investors.

Only the last option, making passive investments in unrelated third parties, is a realistic alternative for diverted profits. Even this alternative, however, may not always be attractive.²⁶⁷ A putative shareholder may find it quite difficult to identify and organize a sufficient number of other shareholders with similar investment strategies and goals to make a decontrolled entity possible, especially if each investor wants to retain significant control over investments.²⁶⁸

(1935); *Bass v. Commissioner*, 50 T.C. 595, 600 (1968). However, these activities may be fairly nominal.

²⁶⁶ This problem can be solved if each shareholder's interest in the foreign entity can be tied to the profitability of the investments made in that shareholder's business operations, rather than the investments made in the other shareholders' businesses. Few taxpayers have attempted this maneuver; it remains to be seen whether one could do so without jeopardizing the desired tax results. See Sheppard, *GM's Class E Stock: Tax Planning in Second Gear*, 36-2 TAX NOTES 130, 135 (1987) (evaluating tax questions created by General Motor's attempt to link return on Class E stock, issued to old shareholders of Electronic Data Systems (“EDS”) in merger transaction, to performance of EDS as a “division”; concluding all predictions of tax consequences rest “on shaky ground”).

²⁶⁷ Further, some investors may prefer retaining access to their “foreign” profits for use in their domestic business operations to achieving the tax benefits obtainable through use of a decontrolled entity. Although it is not impossible to access profits invested through a decontrolled entity, it is fairly difficult to do so. One court-approved method a shareholder may use to gain access to such profits is to pledge his or her shares in the decontrolled entity as security for a loan. See *Ludwig v. Commissioner*, 68 T.C. 979 (1977). Although Treasury subsequently adopted a regulation that impairs the ability of some stockholders of controlled foreign corporations to utilize this technique, see *Treas. Reg. § 1.956-2(C)(2)*, this regulation should not adversely impact shareholders in decontrolled entities.

²⁶⁸ Indeed, Congress relied on the inability of approximately the same number of individuals to agree on such a strategy when it enacted the statutory precursors of the Subpart F regime (the “personal holding company” and “foreign personal holding company” provisions of the Code). See Lubick, *Personal Holding Companies—Yesterday, Today and Tomorrow*, 42 TAXES 855, 860 (1964).

Like Subpart F, these provisions (now codified at I.R.C. §§ 541-47; 551-58) accord especially unfavorable tax treatment to a particular class of income derived by narrowly defined types of entities. The personal holding company provisions impose a 50% penalty tax on the undistributed “personal holding company income” of “personal holding companies.” I.R.C. § 541 (corporations more than 50% of whose stock (measured by value) is held by 5 or fewer individuals, I.R.C. § 542(a)(2), and 60 percent or more of whose adjusted gross income is “personal holding company income,” I.R.C.

However, in the absence of a personal or institutional stake in any particular investment, an acceptable compromise (both immediately and in the future) is more likely than in alternative situations. Thus, the Subpart F rules allow some leeway for achieving advantageous tax treatment.

The class of investors most willing to reinvest foreign earned profits in stocks and securities of unrelated entities and in other passive investments are those investors whose underlying business is to make passive investments. Moreover, the same attributes which allow compromise on the reinvestment decision extend (with similarly beneficial effects) to the initial investment decisions. The public choice constraint is not as effective on passive investors as it is on investors operating active businesses because the dilemmas are not as acute for passive investors as for active ones, and because compromises are easier to work out. As a result, it is easier to form and maintain relatively large groups of passive investors than active investors. This is significant because if a group is large enough, it falls outside Subpart F.

Congress has responded to the greater ability of passive investors to avoid Subpart F. As early as 1962, Congress included a more stringent rule for insurance companies, one variety of passive investors.²⁶⁹ The rule reduced the more than 50% United States ownership requirement for controlled foreign corporation status to a more than 25% ownership standard for foreign insurers receiving more than 75% of their gross "premiums or other consideration" from the insurance of United States risks or lives.²⁷⁰ Congress specifically intended the amendment "to cover cases where the principal business is the U.S. risks but the control is decreased in order to

§ 542(a)(1)). United States shareholders of "foreign personal holding companies" (foreign corporations more than 50% of whose stock (measured by voting power or value) is owned by 5 or fewer individual citizens or residents of the United States, I.R.C. § 552(a)(2), and 60% or more of whose adjusted gross income is comprised of "foreign personal holding company income," I.R.C. § 552(a)(1)) must include their pro rata share of this corporate income in their gross income on a current basis. I.R.C. § 551(a). Both types of personal holding company income include dividends, interest, certain rents and royalties, and income generated from personal service contracts. I.R.C. §§ 543, 553. "[F]oreign personal holding company income" also includes gains from the sale or exchange of stocks, securities, and commodities futures. I.R.C. § 553(a)(2)-(3).

²⁶⁹ Although some portions of an insurance company's business are indisputably "active," a key portion consists of building up reserves through investment of premium dollars. See Note, *Revenue Ruling 77-316 and Carnation Co. v. Commissioner: An Analysis of the Attack on Captive Offshore Insurance Companies*, 2 VA. TAX REV. 111, 113 (1982) (pointing out one advantage of using captive insurance companies is that a "captive controls its own investment decisions").

²⁷⁰ Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1008 (codified as amended at I.R.C. § 957(b)).

avoid application of this provision.”²⁷¹ At the same time, Congress imposed a different, but almost equally stringent taxing regime on United States persons owning stock in “foreign investment companies,” foreign corporations which were either registered under the Investment Company Act of 1940 as management companies or as unit investment trusts,²⁷² or were primarily engaged in the business of investing, reinvesting, or trading in securities at a time when United States persons held a majority of the voting power or value of its stock.²⁷³ United States persons owning interests in foreign investment companies had to report all gain from the sale or exchange of these interests as ordinary income²⁷⁴ or, if the company made the necessary election, they could receive 90% of their share of the corporation’s taxable income on an annual basis with the remainder realized as capital gain on the eventual sale or exchange of the shares.²⁷⁵

C. Revisitation of the Rules

Over time, Congress became convinced that both of these regimes were too narrow,²⁷⁶ and it included provisions in the 1986

²⁷¹ H.R. REP. No. 1447, *supra* note 234, at 60; S. REP. No. 1881, *supra* note 252, at 82. Interestingly, this rule only led to taxation of insurance companies’ “net underwriting income” attributable to the insurance of United States risks, the income “which would (subject to certain modifications) be taxed under Subchapter L of Chapter 1 if the controlled foreign corporation were a domestic insurance corporation.” S. REP. No. 1881, *supra*, at 242. See I.R.C. § 953(a)(2). Most of an insurance company’s passive income remained free of domestic tax. See Note, *supra* note 269, at 111 (Subpart F leaves “largely undisturbed” the tax benefits of using an offshore captive insurer). As a result, the Internal Revenue Service challenged some of these arrangements by contending that the arrangements did not provide insurance because the risks being insured remained within the economic family and, hence, disallowed the parent’s deduction of insurance premiums paid to the captive. See, e.g., Rev. Rul. 77-316, 1977-2 C.B. 53; *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff’d*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981). However, by the Service’s own admission, multiple ownership of the captive, as well as the issuance of policies to unrelated insureds, destroys this ground of attack. See Rev. Rul. 78-338, 1978-2 C.B. 107 (allowing deduction for premiums paid to insurance “captive” owned by, and insuring the risks of, 31 unrelated parties).

²⁷² Revenue Act of 1962, Pub. L. No. 87-834, § 14, 76 Stat. 960, 1036 (codified as amended at I.R.C. § 1246(b)(1)).

²⁷³ Revenue Act of 1962, Pub. L. No. 87-834, § 14, 76 Stat. 960, 1036-37 (codified as amended at I.R.C. § 1246(b)(2)).

²⁷⁴ Revenue Act of 1962, Pub. L. No. 87-834, § 14, 76 Stat. 960, 1036 (codified as amended at I.R.C. § 1246(a)).

²⁷⁵ Revenue Act of 1962, Pub. L. No. 87-834, § 14, 76 Stat. 960, 1036 (codified as amended at I.R.C. § 1246(a)(1)).

²⁷⁶ See S. REP. No. 313, *supra* note 62, at 393:

The committee understands that the abuses the Congress was concerned with in 1962 when the foreign investment company provisions were enacted have advanced to a point where present law is basically inoperative. The committee is aware that present foreign corporations that invest in passive assets limit U.S. ownership in such funds so that Section 1246 rarely applies.

Tax Act to further limit opportunities for United States taxpayers to achieve deferral advantages for foreign-earned passive income. These provisions broaden the scope of the special foreign insurance company regime and establish a new taxing regime applicable to so-called "passive foreign investment companies."

1. *Extending the Foreign Insurance Company Regime*

The 1986 Tax Act broadens the scope of the special insurance provisions in three ways. First, it greatly expands the amount of an insurance company's receipts potentially includable in the current income of a United States shareholder under Subpart F. Second, it loosens the controlled foreign corporation's United States ownership provisions for some Subpart F purposes. Finally, the 1986 Tax Act narrows the *de minimis* exception formerly applicable to insurance income. Each of these changes is explained in greater detail below.

The expansion of includable receipts is accomplished through two distinct changes: elimination of exclusions for income generated by the investment of unearned premiums, reserves, and certain other funds from personal holding company income;²⁷⁷ and expansion of the definition of "insurance income" includable in Subpart F income. The definition of "insurance income" now includes income attributable to the insurance of risks arising in any country other than "the country under the laws of which the controlled foreign corporation is created or organized[.]"²⁷⁸ Thus, if the foreign insurance company is a controlled foreign corporation, only insurance income attributable to risks located in its country of incorporation qualifies for deferral; all other income is taxed (through its United States shareholders) approximately as if the insurance company were a domestic corporation.²⁷⁹

Congress also increased the likelihood that some insurance income would be includable in United States stockholders' income under Subpart F by further loosening the controlled foreign corporation's United States ownership requirements for purposes of de-

Id.

²⁷⁷ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(a)(1), 100 Stat. 2085, 2549 (amending I.R.C. § 954(c)). See also *supra* note 271 (describing effect of prior exclusions).

²⁷⁸ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(b)(1), 100 Stat. 2085, 2551 (amending I.R.C. § 953(a)). Prior to the 1986 Tax Act, only income attributable to risks arising in the United States were included. I.R.C. § 953(a)(1) (1985).

²⁷⁹ United States shareholders pay United States tax on their pro rata shares of the corporation's Subpart F income; if the entire corporation is owned by United States shareholders, all of its Subpart F income is subject to domestic tax on a current basis. Otherwise includable Subpart F income avoids domestic tax completely, of course, to the extent it is attributable to shares held by foreigners.

termining the tax treatment of "related person insurance company income." "Related person insurance company income" is all "insurance income" attributable to the reinsurance of risks whose primary insured is a United States shareholder (or a person related to such a shareholder)²⁸⁰ of the foreign insurer.²⁸¹ Noting that the widely dispersed ownership of some captive insurance companies allowed many shareholder-insureds to escape current taxation under Subpart F,²⁸² Congress added a rule deeming all United States persons owning any stock in a foreign insurance company "United States shareholder[s]" for purposes of determining the tax treatment of "related person insurance income."²⁸³ Thus, if the combined ownership percentage (measured by voting power or value)²⁸⁴ of the United States persons owning stock in the company equals or exceeds 25%, then each United States person, no matter how small its ownership interest, must include its pro rata share of the corporation's "related person insurance company income" in its gross income on a current basis.²⁸⁵

Finally, the 1986 Tax Act repeals the rule applicable to insurance income²⁸⁶ and collapses it into a narrower test formerly applicable only to foreign base company income.²⁸⁷ Prior law excluded foreign base company income from Subpart F income if it comprised less than 10% of the controlled foreign entity's gross income.²⁸⁸ The old law excluded insurance income from Subpart F income if it amounted to 5% or less of the total of premiums and

²⁸⁰ See I.R.C. § 954(d)(3) (defining related person).

²⁸¹ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(b)(2), 100 Stat. 2085, 2551 (currently codified at I.R.C. § 953(c)(2)). The regulations to be promulgated under this provision will also apply to mutual insurance companies and will treat the mutual company policyholders as if they were shareholders of a stock company. I.R.C. § 953(c)(4).

²⁸² H.R. CONF. REP. No. 841, *supra* note 81, at pt. 2 at 617 (shareholders with less than 10% of company's stock did not fall within Subpart F).

²⁸³ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(b)(2), 100 Stat. 2085, 2551 (currently codified at I.R.C. § 953(c)(1)).

²⁸⁴ See I.R.C. § 957(b).

²⁸⁵ The Code allows foreign insurers to avoid this rule (and exclude their "related party insurance income" from income) in three situations: (1) where less than 20% of the company's shares (measured by voting power or value) are owned by the primary insured parties (or related parties) under policies of insurance or reinsurance issued by the company, I.R.C. § 953(c)(3)(A); (2) where the company derives less than 20% of its insurance income in the form of related person insurance income, I.R.C. § 953(c)(3)(B); and (3) where the company elects to treat related person insurance income as income "effectively connected with the conduct of a trade or business in the United States" (subjecting it to normal income taxation in the United States), I.R.C. § 953(c)(3)(C).

²⁸⁶ See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(b)(1), 100 Stat. 2085, 2551 (codified at I.R.C. § 953(a)); H.R. CONF. REP. No. 841, *supra* note 81, at pt. 2 at 616.

²⁸⁷ See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1223(a), 100 Stat. 2085, 2557-58; H.R. CONF. REP. No. 841, *supra* note 81, at pt. 2 at 627.

²⁸⁸ See I.R.C. § 954(b)(3) (1985).

other consideration received during the year.²⁸⁹ Together, these two rules allowed entities to receive as much as 15% of their gross income in the form of Subpart F income and still avoid Subpart F's strictures. After the 1986 Tax Act, however, an entity's foreign base company and insurance income must be added together and may be excluded from income only if the total is below the lesser of 5% of the corporation's gross income or \$1,000,000.²⁹⁰

These changes fundamentally alter the scope of Subpart F's insurance provisions. Though their precise impact is not yet known, Congress expects that they will raise a significant amount of revenue. The five year revenue estimate projects a revenue gain of \$184 million from the captive insurance company provisions alone.²⁹¹ Other Subpart F changes are expected to raise \$685 million.²⁹²

2. *The New PFIC Regime*

The most significant of the international tax reforms in the 1986 Tax Act is a new taxing regime aimed specifically at "passive foreign investment companies," or "PFICs". United States investors in PFICs, no matter how small their holdings and without regard to the overall level of United States ownership of the PFIC, fall within a special taxing regime²⁹³ designed to eliminate the benefits of deferral.²⁹⁴

The Code defines a PFIC as any foreign corporation which derives 75% or more of its gross income in the form of passive income, or holds 50% or more of its assets (by value) for the production of passive income.²⁹⁵ "Passive income" for these purposes consists generally of income within the definition of passive income in the foreign tax credit context²⁹⁶ (which in turn refers to foreign personal holding company income and personal holding company income).²⁹⁷ It includes dividends, interest, royalties, rents, annuities, net gains from the sale of non-inventory or non-dealer property, net non-trade or business commodities gains, net

²⁸⁹ See I.R.C. § 953(a) (1985).

²⁹⁰ I.R.C. § 954(b)(3).

²⁹¹ H.R. CONF. REP. NO. 841, *supra* note 81, at pt. 2 at 880.

²⁹² *Id.* at pt. 2 at 879. Not all of this gain comes from amendments to the insurance company rules. Congress made numerous other changes to Subpart F at the same time. The revenue estimates, however, do not associate specific revenue gains with particular amendments.

²⁹³ Rubinfeld & Rubin, *Passive Foreign Investment Companies: The Pentapus Becomes the Sextapus, Or Does It?*, 36 TAX NOTES 199, 204 (July 13, 1987).

²⁹⁴ See S. REP. NO. 313, *supra* note 62, at 394; H.R. CONF. REP. NO. 841, *supra* note 81, at pt. 2 at 641.

²⁹⁵ I.R.C. § 1296(a); Rubinfeld & Rubin, *supra* note 293, at 204.

²⁹⁶ I.R.C. § 1296(b).

²⁹⁷ I.R.C. § 904(d)(2)(A).

foreign currency gains (to the extent not directly related to the business needs of the corporation), and certain income economically equivalent to, but not denominated as, interest.²⁹⁸ It does not include any income from the active conduct of a trade or business, including a banking or insurance business.²⁹⁹

The tax treatment of United States investors in a PFIC depends upon whether the corporation elects to be treated as a "qualified electing fund" ("QEF"). Absent such an election, any United States investor who disposes of PFIC stock at a gain or receives a "total excess distribution"³⁰⁰ with respect to such stock must allocate the amount of that gain or total excess distribution among the taxable years the taxpayer held the stock.³⁰¹ The shareholder then includes amounts attributable to the current year and any year during which the corporation was not a PFIC in its gross income for the current year as ordinary income.³⁰² To calculate the tax due on amounts allocated to other years, however, the taxpayer multiplies each year's amount by the highest rate of tax in effect for such taxable year under section I or section 11.³⁰³ The taxpayer also must pay an interest charge calculated by applying the Code's rate for underpayments of tax to the tax due with respect to each year for the period running from the due date of that year's tax return until the due date for the return in the year of the disposition or distribution.³⁰⁴ This levy places the taxpayer in the same economic position as if the gain or excess distribution amounts had been distributed in

²⁹⁸ See I.R.C. § 954(c); Rubinfeld & Rubin, *supra* note 293, at 204-05. The Act made a number of changes in the definition of "foreign personal holding company income," in order to broaden the definition's scope. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(a)(1), 100 Stat. 2085; H. R. CONF. REP. NO. 841, *supra* note 81, at pt. 2 at 611, 613-16 (describing changes); Turner, *Foreign Taxation Highlights of the Tax Reform Act of 1986*, 21 INT'L LAW. 487, 511-512 (1987) (same).

²⁹⁹ I.R.C. § 1296(b)(2). Congress's exemption of these and other active foreign businesses from PFIC treatment requires the elimination of indirect taxation through a foreign holding company parent. See H. R. CONF. REP. NO. 841, *supra* note 81, at pt. 2 at 644. Accordingly, if a parent corporation owns at least 25% (by value) of the stock of a subsidiary, a special lookthrough rule treats the parent as owning that portion of the subsidiary's business income. I.R.C. § 1296(c). The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1012(p)(2), 102 Stat. 3342, extends this lookthrough rule to indirectly owned, lower-tier subsidiaries.

³⁰⁰ The Code defines "total excess distribution" as the amount of distributions received with respect to stock during a taxable year in excess of 125% of the average amount received in respect of such stock during the preceding three taxable years. I.R.C. § 1291(b)(2)(A). The rule does not apply during the first taxable year the investor holds the stock. I.R.C. § 1291(b)(2)(B).

³⁰¹ Taxpayers ratably allocate the amounts to each day of their holding period for the stock. I.R.C. § 1291(a)(1)(A).

³⁰² I.R.C. §§ 1291(a)(1)(B), 1291(a)(2).

³⁰³ I.R.C. §§ 1291(a)(1)(C), 1291(c)(2).

³⁰⁴ I.R.C. § 1291(c)(3).

the form of a dividend in the year they were deemed earned.³⁰⁵

United States shareholders of a corporation which elects to become a QEF³⁰⁶ avoid the interest charge and recharacterization rules described above for gains and income attributable to years during which a QEF election is in effect.³⁰⁷ Instead, they are required to include their pro rata share of the QEF's profits in their own gross income on a current basis, and pay current United States tax on that amount.³⁰⁸ Alternatively, shareholders may elect to defer payment of these taxes in exchange for an agreement to pay interest on the deferred amount.³⁰⁹ In either case, the regime places investors in approximately the position they would have been in had they held their share of the assets directly.

4. *Definitional Reforms*

Congress's replacement of the public choice constraint with a more comprehensive device for taxing United States investor-owned, foreign-earned, passive income is not a complete rejection of the public choice constraint as a method for controlling tax avoidance in the international arena. The constraint remains important for discouraging the diversion of active business income to low tax jurisdictions. Indeed, one of the changes in the Subpart F rules made by the 1986 Tax Act increases the effect of the public choice constraint by making it more difficult for a taxpayer to assemble large numbers of shareholders³¹⁰ in circumstances which will avoid conflicts of interest.

One method of assembling enough shareholders to escape Subpart F's strictures without running the risk of their developing debilitating conflicts of interest is to use related taxpayers and, in

³⁰⁵ Congress clearly intended that United States investors in PFIC's "pay U.S. tax plus an interest charge based on the value of tax deferral," thereby "eliminating the economic benefits of deferral." H.R. REP. No. 841, *supra* note 81, at pt. 2 at 641. However, under some circumstances, this taxing regime goes further and imposes a heavier tax burden on investors than would have resulted if the PFIC distributed all its earnings and profits on a current basis. See Rubinfeld & Rubin, *supra* note 293, at 206-07.

³⁰⁶ QEF status requires both filing the necessary election form and providing the Internal Revenue Service with certain types of information. I.R.C. § 1295(a). An election, once made, can be revoked only with the permission of the Secretary. I.R.C. § 1295(b)(1). See also Temp. Treas. Reg. § 1.1291-10T (outlining election procedures).

³⁰⁷ I.R.C. § 1291(d)(1); Rubinfeld & Rubin, *supra* note 293, at 208.

³⁰⁸ I.R.C. § 1293(a)(1). Such amounts retain their QEF status in the shareholder's hands. Also, 10% shareholders may claim an appropriate foreign tax credit to offset the United States tax liability. I.R.C. § 1293(f).

³⁰⁹ I.R.C. § 1294. Substantial restrictions apply to this election privilege. For example, the privilege is not available for amounts otherwise includable under Subpart F or the foreign personal holding company rules. See I.R.C. § 1294(b); Rubinfeld & Rubin, *supra* note 293, at 209-10.

³¹⁰ A taxpayer in this situation will try to find enough shareholders to avoid "controlled foreign corporation" status. See *supra* text accompanying note 261.

particular, entities related through common ownership. A common owner has both the power and the incentive to resolve any conflicts that might arise among the shareholders because it can internalize and weigh the benefits and disadvantages of each course of action.³¹¹ In fact, this escape from Subpart F is so obvious that when the regime was first enacted, Congress included in it an attribution rule which treats all the holdings of related taxpayers as held by one taxpayer for purposes of determining whether a foreign corporation is a "controlled foreign corporation."³¹² The rule also treats each shareholder as holding all the shares owned by related taxpayers for purposes of determining whether any particular shareholder is a United States shareholder.³¹³ Thus, distributing the ownership of a foreign corporation, X, equally among eleven domestic subsidiaries of a United States parent, A, gains no tax advantages for A. The Code deems X a controlled foreign corporation and deems each of the subsidiaries a United States shareholder required to report its pro rata share of X's Subpart F income on a current basis. As a result, all of X's Subpart F income is taxed in the United States on a current basis.

Closing this escape route did not, however, prevent taxpayers from experimenting with similar schemes. One which speedily developed was to create a separate class of stock designed for distribution to unrelated, generally foreign shareholders. Though this class of stock had to be assigned enough voting power to avoid classification of the corporation as a controlled foreign corporation (i.e. 50% of the total voting power),³¹⁴ it also contained features which made the foreign shareholders unlikely ever to desire to exercise this power contrary to the United States shareholders' interests. In particular, such shares tended to bear guaranteed, limited dividend rights and preferential redemption or liquidation rights, which isolated holders from participation in either the upside returns or downside risks of the corporation's activities. The fact that the shares typically represented a very small proportion of the corporation's total capitalized value provided further isolation from eco-

³¹¹ As the ultimate beneficiary of the profits and losses generated by each of its subsidiary corporations, a parent corporation or entity has an incentive to maximize the joint profits of the combined group. If this joint maximization strategy involves short-changing one of the subsidiaries, the shortfall can be remedied through a series of inter-corporate dividends or capital contributions; in all probability, however, the group can ignore the shortfall.

³¹² See Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, I018-19 (codified as amended at I.R.C. § 958(b)). The rule also traces ownership back to United States individuals and entities through intermediary foreign corporations. See *id.* (codified as amended at I.R.C. § 958(a)).

³¹³ *Id.*

³¹⁴ See I.R.C. § 957(a) (1985).

conomic risk. Nothing short of a major disaster could imperil the shareholders' returns and they would not benefit from increased profits so these shareholders had nothing to gain by participating in corporate management. Formal control was thus alienated without the loss of effective control.³¹⁵

Schemes like this were obvious enough that Treasury included a regulation in its first set of Subpart F regulations allowing the Internal Revenue Service to disregard "[a]ny arrangement to shift formal voting power away from United States shareholders . . . if in reality voting power is retained."³¹⁶ However, by its terms, the regulation requires that the Service prove "the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise their voting rights, and . . . a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957."³¹⁷ Though most courts have upheld the Service's attacks on particular taxpayers engaged in such schemes,³¹⁸ litigating these evidentiary issues is necessarily expensive for the Service and results are uncertain.³¹⁹ The 1986 Tax Act removes any temptation for taxpayers to chance the litigation odds, however, by broadening the definition of a controlled foreign corporation to include any foreign corporation where United States shareholders own a majority of the stock—measured by voting power *or* value.³²⁰ The new rule makes it much more expensive for corporations to achieve decontrol by maintaining a second class of stock and may make maintaining a class of passive shareholders impossible. Owners of a majority of the stock's value (and by definition the recipient of half of any increase in

³¹⁵ See, e.g., *Kraus v. Commissioner*, 59 T.C. 681, 696 (1973) ("[T]he petitioners never intended to part with any voting control . . . nor did the preferred shareholders intend to use the voting power nominally carried by their stock."), *aff'd*, 490 F.2d 898 (2d Cir. 1974); *Garlock, Inc. v. Commissioner*, 58 T.C. 423, 435-36 (1972), *aff'd*, 489 F.2d 197 (2d Cir. 1973) (describing plan "to pass 50% of the voting rights to foreigners who [would] not have any interest in exercising their vote independently" [of the petitioner's stock as] . . . nothing could be gained thereby"), *cert. denied*, 417 U.S. 911 (1974).

³¹⁶ *Treas. Reg. § 1.957-1(b)(2)* (1987) (promulgated in T.D. 6688, 1963-2 C.B. 321).

³¹⁷ *Id.*

³¹⁸ See *Koehring Co. v. United States*, 583 F.2d 313 (7th Cir. 1978); *Kraus*, 56 T.C. 681; *Garlock Inc.*, 58 T.C. 423.

³¹⁹ See AMERICAN LAW INSTITUTE, *supra* note 235, at 237 ("vagueness of the factual questions posed by the Regulation . . . raise difficult audit problems for the Internal Revenue Service and invite dispute"). The Service lost one of these cases, *CCA, Inc. v. Commissioner*, 64 T.C. 137 (1975), *acq.*, 1976-2 C.B. 1 (withdrawn), *non acq.*, 1982-1 C.B. 1.

³²⁰ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1222(a)(1), 100 Stat. 2085, 2556-57 (codified at I.R.C. § 957(a)).

value)³²¹ will be intensely interested in its business plans. The Committee Reports state in no uncertain terms that the change is intended to ward off further attempts at "manipulation."³²²

IV LESSONS FOR THE FUTURE

In sum, although Congress does not explicitly recognize the public choice constraint as a method of controlling undesirable tax avoidance and has not used the restraint with unqualified success, the constraint has significantly helped in some instances. The circumstances in which it has proved most successful, as well as those surrounding its failures, are important because they provide an indication of where such constraints may (or may not) be useful in the future.

The first circumstance worth noting is the time factor. For the constraint to be effective in the tax context, it almost has to apply to relationships spanning a fairly lengthy time period. The reason for this is simple; the success of the constraint depends on the taxpayers' having disparate preferences. At any given point in time, a taxpayer is likely to be able to find others with similar preferences or desires because there are a great many taxpayers to choose from. Although finding short term allies may be difficult or expensive, it is not impossible. By contrast, finding long term allies, groups of taxpayers whose desires and needs will remain congruent over time, is nearly an impossible task. Success requires accurate projections of future events and future attitudes. Not only is accuracy elusive, it is difficult to convince others of the accuracy of predictions. Lack of belief in the accuracy of the necessary predictions will cause the venture to fail just as surely as an actual mistaken prediction since nonbelievers would refrain from joining the group initially. In the international tax context, for instance, there is little net benefit in establishing a decontrolled entity if shareholder dissension forces its dissolution within a few years. Limited upside returns like this counsel against incurring the initial expense of establishing such an entity.³²³

The second prerequisite for the successful operation of the public choice constraint is most clearly evident in the passive income area; not only must the taxpayers' interests be disparate, but strongly so. Taxpayers may overlook relatively small differences in

³²¹ The outside shareholders must get half of the increase in value or their interests in the corporation will drop below the 50% threshold.

³²² S. REP. NO. 313, *supra* note 62, at 371; H.R. REP. NO. 426, *supra* note 82, at 402.

³²³ See also *supra* note 185 (describing effect of time on maintenance of fringe benefits plan).

opinion or utility or develop a compromise package when significant tax benefits result. By contrast, if a taxpayer feels strongly about a particular outcome—if, for example, it is counting on an infusion of cash from its foreign related entity to fulfill business expansion plans or foresees heavy medical expenses in the immediate future—there is less basis for compromise. Stated simply, as it becomes more important for the taxpayer to “have it his way,” the possibility that obstacles may be placed in that path becomes a more serious disadvantage.

Finally, although the effect of the public choice constraint may approach that of an outright prohibition on certain tax consequences, opportunities usually exist for some taxpayers to obtain favorable tax treatment. The resulting inequality may not be acceptable on normative grounds. The operation of the public choice constraint in the fringe benefit context provides a perfect example of how this issue arises. Although it makes some sense to use nondiscrimination rules to redistribute “excess tax benefits” from employers and highly paid employees to lower paid employees,³²⁴ the logic (aside from the obvious revenue effects) behind allocating tax benefits based on the homogeneity of employee groups’ consumption patterns remains mysterious. In the vast majority of cases, one cannot argue seriously that homogeneity indicates that such benefits are more “job related,” especially inasmuch as truly job related benefits are completely exempt from the necessity of satisfying any nondiscrimination standards.³²⁵ Further, allowing employees to choose between equally valuable benefits probably increases rather than decreases equality in their subjective valuations of their wage packages. Participating employees will derive more equal benefits from the tax favor granted fringes and will avoid having some employees

³²⁴ This scheme also has a number of flaws. Perhaps the most important is that the size of the levy on rich employers and employees (and the corresponding take of poor employees) depends on the composition of the entire work force, including its salary structure, and its members’ tastes for fringe benefits, rather than the amount of available excess tax benefits. Some taxpayers will lose all their excess, while others retain all or most of theirs solely because of dissimilar co-workers. Meanwhile, some low paid employees will be denied redistributive gains because their co-workers do not generate enough excess to make a plan worthwhile from the employer’s perspective. In sum, the scheme still leaves room for considerable disparity in the distribution of tax benefits. *Cf.* Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX. L. REV. 433, 466-69 (1987) (describing situations in which the 1986 Tax Act definition of “suspect group” will aggravate inequality of provision of pension benefits); Wolk, *Discrimination Rules for Qualified Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 432-34 (describing similar problems with pension plan nondiscrimination rules).

³²⁵ See I.R.C. § 132(h)(1) (excluding “working condition fringes” from purview of nondiscrimination rule applicable to other fringe benefits authorized under section 132).

derive a very valuable benefit, while others derive very little. Finally, the modified form of the constraint in the current nondiscrimination rules undoubtedly favors large organizations over small ones because random variations in preference patterns are more likely to cause problems for smaller employee groups than for larger ones. It seems far more probable, for example, that a situation will arise where only executives desire dependent care and only the rank and file desire legal insurance when the entire group consists of three executives and twenty employees than when it consists of twenty executives and three hundred employees. The larger their group, the more likely it is that the executives' interests will diverge so that some desire fringe benefits other than dependent care. Further (and for the same reason) at least some of the larger group of employees are likely to want dependent care.³²⁶ In short, the distributional patterns created by the operation of the public choice constraint in the fringe benefit context may be impossible to accept over the long term.³²⁷

By contrast, the number of unrelated shareholders necessary to escape Subpart F may make it so difficult (or unrewarding) to exaggerate profits earned by the foreign corporation (and diverted from the United States shareholders' domestic corporations) that widely held foreign corporations simply will not participate in such schemes. Their income would then be only singly, and not doubly, suspicious and disfavored.³²⁸ Allowing these widely held foreign corporations the advantage of deferral might not, therefore, seem terribly inequitable or dangerous to the federal fisc. The lack of possibilities for abuse may justify better tax treatment than accorded those with opportunity to abuse the benefit. Thus, the use of a pub-

³²⁶ Of course, if a small enough group of employees is involved, the employer may try to hire only those employees who share the fringe benefit preferences of the employer's executives. That may, however, not be practicable given the size of the employer's applicant pool.

³²⁷ Indeed, if Congress and/or Treasury were truly strategic, one could contend that the initial objective in using the public choice constraint was to create this distressing state of affairs, thereby generating political support for the imposition of more straightforward and even-handed (but equally revenue protective) limits on fringe benefits. Although no groundswell of support for such a proposal has materialized to date, small-business representatives have already begun to complain about the effect the new rules will have on small businesses' ability to sponsor welfare benefit plans. So far, however, their complaints have focused on the cost of administering the new standards, rather than the standards themselves. See, e.g., *Welfare Plan Non-Discrimination Rules, Other Changes Concern Benefit Experts*, 13 Pens. Rep. (BNA) 1203, 1203 (July 7, 1986); Sheppard, *Lots of Questions, Few Answers on Employee Benefit Complaints*, 33 TAX NOTES 1086, 1088 (1986). This focus may shift once section 89 goes into effect, and taxpayers find out how difficult it is to meet the standards established therein.

³²⁸ See *supra* text accompanying notes 252-53.

lic choice constraint rather than the imposition of a flat prohibition may not create an additional inequity.

CONCLUSION

This Article illustrates situations where the Code relies on disparate interests of superficially similarly situated taxpayers to curb abusive behavior.³²⁹ These disparities affect taxpayer behavior. How much of a constraint they exert, and whether the exploitation of that constraint can be squared with other goals or norms of the tax system, remains to be explored. While Congress takes advantage of the public choice constraint, it has avoided open discussion not only of whether the constraint is the most appropriate response to the problem at hand but also of the very fact that it uses the constraint. It is time to confront these issues directly so that Congress can reach a rational concensus as to the constraint's desirability in the fringe benefit and Subpart F rules as well as its possible application to other perennial problem areas of the Code.

³²⁹ Although it has long been accepted that our tax system relies on the selfish behavior of some taxpayers to keep other taxpayers honest, this phenomenon has only been discussed in the context of taxpayers on opposite ends of a business transaction. The Code contains numerous provisions covering situations where parties have shared, rather than the expected antagonistic, interests. *See, e.g.*, I.R.C. § 269 (disallowing losses triggered by transactions between related parties); I.R.C. § 465 (limiting basis created through nonrecourse financing); I.R.C. § 1239 (recharacterizing gain from the sale of depreciable property between related taxpayers).