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# **The Moratorium is Over: Fringe Benefits Under the Tax Reform Act of 1984**

**Julia Kalmus†**

## **I. Codification of Fringe Benefits**

On July 18, 1984, President Reagan signed into law the Tax Reform Act ("Act") of 1984.<sup>1</sup> The Act contains the long-awaited codification of fringe benefit taxation, finally ending the moratorium that Congress imposed in 1977. In place of the moratorium, the Act provides a series of new statutory rules that determine when fringe benefits constitute taxable compensation to employees.

The Act provides a broad range of fringe benefits that are excluded from employees' gross income for federal income tax purposes.<sup>2</sup> Any fringe benefit that does not qualify for exclusion under one of these categories, or that is not specifically excluded under another provision of the Internal Revenue Code (Code), is includable in the recipients' gross income<sup>3</sup> at the excess of its fair market value over any amount paid by the employee for the benefit.<sup>4</sup> These new rules will exert a considerable influence in employers' decisions regarding what fringe benefits to provide to employees in the future.

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1. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.).

2. They are also excluded from the wage and benefit base for purposes of social security and other employment tax. H.R. Rep. No. 432, 98th Cong., 2d Sess. 1590, 1593, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 520, 523 [hereinafter cited as HOUSE REPORT].

3. Fringe benefits are includable in the recipients' gross income under § 61(a)(1), which was amended by the Act to specifically include "fringe benefits" in its definition of compensation. I.R.C. § 61(a)(1), [1 Code] FED. TAXES (P-H) 24,204, 24,205 (July 18, 1984).

4. *Id.* See also HOUSE CONF. REPORT, No. 861 98th Cong., 2d Sess. 757, 1169, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 751, 1163 [hereinafter cited as CONFERENCE REPORT].

## II. Fringe Benefit Taxation Prior to the Tax Reform Act of 1984

In addition to cash compensation, employers often provide a variety of non-cash fringe benefits to their employees. Some types of fringe benefits<sup>5</sup> are provided to the employee directly in kind. Others are given as reimbursements for specific expenses incurred by the employee.

For income tax purposes, section 61 of the Internal Revenue Code defines gross income as including "all income from whatever source derived"<sup>6</sup> and specifies that it includes "compensation for services"<sup>7</sup> and "non-cash remuneration."<sup>8</sup> In *Commissioner v. Smith*,<sup>9</sup> the Supreme Court concluded that the definition of compensation was "broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."<sup>10</sup> In theory, the value of all forms of compensation constitute taxable income to the employee. In practice, however, this is not always so. In many cases, taxability is tied directly to the form of compensation. Cash benefits are almost always taxable, whereas non-cash benefits are often exempt from taxation.<sup>11</sup>

An item of economic benefit received from an employer will not constitute taxable income to the employee if the item was

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5. For the purpose of this Article, the term "fringe benefits" includes all personal benefits, aside from cash compensation, provided to an employee by an employer in connection with the employee's performance of services.

6. I.R.C. § 61(a) (West 1984).

7. *Id.* § 61(a)(1).

8. Non-cash remuneration is generally subject to Social Security (FICA), unemployment insurance payroll tax (FUTA), and income tax withholding under pre-1984 law. FICA, FUTA, and income tax withholding are applied to wages. "Wages" are defined in the applicable statutes as "all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash." I.R.C. §§ 3121(a), 3306(b) (West 1984). See also *id.* § 3401(a) (which substitutes "for services performed by an employee for his employer" for the words "for employment"). The Railroad Retirement Tax (RRTA) applies to any form of money remuneration. *Id.* § 3231(e). See also Treas. Reg. § 1.61-1(a) (1984).

9. 324 U.S. 177 (1945).

10. *Id.* at 181. The Supreme Court was speaking of compensation under the predecessor provision to § 61.

11. Kusters and Steverle, *The Effect of Fringe Benefit Tax Policies On Labor and Consumer Markets* in TAX INSTITUTE OF AMERICA PROCEEDINGS OF THE SEVENTY-FOURTH ANNUAL CONFERENCE 86, 90 (1981).

not provided to the employee as "compensation." If a benefit is provided to an employee primarily for a business purpose of the employer, and not as compensation to the employee, it is not considered to be a taxable fringe benefit to the employee even if the employee also receives a personal benefit.<sup>12</sup> For example, if an employer provides a salesman with a company car for use in calling on customers, the use of the car is not considered a "fringe benefit" provided to the employee, but rather a business expense of the employer. This is so even though the car benefits the employee because it is easier to use a car than to take the subway. Under certain circumstances a benefit must be apportioned with part included in income and part excluded. If, in the example just mentioned, the salesman had full-time use of a company car for both business and personal use, the value of the car's personal use, but not its business use, would be included in the employee's gross income.<sup>13</sup>

In certain circumstances, a benefit received by an employee may be characterized as a "gift," and therefore not includable in the employee's gross income. However, proving that such a benefit is not actually compensation may be difficult. In *Commissioner v. Duberstein*,<sup>14</sup> the Supreme Court explained that it would be skeptical of characterizing a benefit as a gift because "it doubtless is, statistically speaking, the exceptional payment by an employer to an employee that amounts to a gift."<sup>15</sup>

Some types of fringe benefits have been made expressly nontaxable by statute. As a general rule, if an employer provided a fringe benefit program that qualifies under a specific statutory provision of the Code, then the value of the benefit provided is excludable from the employee's gross income for income tax purposes.<sup>16</sup> The cost of the benefit that is excluded from the em-

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12. Wasserman, *Principles of Taxation of Nonstatutory Fringe Benefits*, 32 TAX LAW. 137, 138-40 (1978).

13. *Id.* at 139.

14. 363 U.S. 278 (1960).

15. *Id.* at 287.

16. Generally, the exclusions are subject to dollar or other limitations and nondiscrimination rules, as to eligibility to participate. *Joint Committee on Taxation Staff Pamphlet Giving Overview of Tax Treatment of Fringe Benefits*, DAILY TAX REP. No. 145, at x-2 (July 27, 1984) [hereinafter cited as *Staff Pamphlet*]. For certain types of benefits, primarily pension plans, the exclusion results in a deferral of taxation. That is, the benefit is taxable only when actually received by the employee (for example at

ployee's income is nonetheless deductible by the employer,<sup>17</sup> presumably to encourage employers to provide these benefits to their employees.<sup>18</sup> The fringe benefits provided for by the Code include:

1. Section 79 — Group-Term Life Insurance;<sup>19</sup>
2. Section 101(b) — Death Benefits;<sup>20</sup>
3. Sections 105 and 106 — Accident and Health Plans;<sup>21</sup>
4. Section 107 — Parsonage Allowances;<sup>22</sup>
5. Section 119 — Meals and Lodgings;<sup>23</sup>
6. Section 120 — Legal Services Plan;<sup>24</sup>
7. Section 124 — Van Pooling;<sup>25</sup>
8. Section 129 — Dependent Care Assistance;<sup>26</sup>
9. Section 127 — Educational Assistance;<sup>27</sup>

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retirement).

17. To be deductible by the employer, the costs of the fringe benefits must constitute ordinary and necessary business expenses. I.R.C. § 162(a) (West 1984).

18. Ferguson, *Income Tax Treatment of Employee Fringe Benefits*, in TAX INSTITUTE OF AMERICA PROCEEDINGS OF THE SEVENTY-FOURTH ANNUAL CONFERENCE 97 (1981). The express statutory exemptions are estimated to have resulted in approximately \$35 billion of tax savings in fiscal year 1981. *Id.* citing *Special Analysis G, Tax Expenditures Special Analyses: Budget of the United States Government, Fiscal Year 1981* (U.S. Gov't Printing Office, 1980).

19. The cost of \$50,000 worth of group-term life insurance, purchased by an employer for an employee for a taxable year, is excluded from the employee's gross income. I.R.C. § 79(a)(1) (West 1984).

20. Up to \$5000 is generally excludable from a beneficiary's gross income if paid by or on behalf of an employer by reason of an employee's death. *Id.* § 101(b)(2)(A).

21. An employer's contributions to a plan providing accident and health benefits are excludable from the employee's gross income. *Id.* §§ 105(a), 106.

22. The rental value of a home provided as part of compensation, or a rental allowance used to rent or provide a home, are excludable from a minister's gross income. *Id.* § 107.

23. The value of certain meals and lodgings furnished to an employee (or to the employee's spouse or dependents) for the convenience of the employer are excluded from the employee's gross income. *Id.* § 119(a).

24. Employer contributions to a qualified prepaid legal services plan, as well as the value of any legal services rendered, are excluded from the employee's gross income. *Id.* § 120(a).

25. The value of certain employer-provided transportation between an employee's residence and place of employment is excluded from the employee's gross income. *Id.* § 124(a).

26. Amounts paid by an employer under a qualified dependent care assistance program are excluded from the employee's gross income. *Id.* § 129(a).

27. Certain amounts paid by the employer in providing educational assistance to the employee are excluded from the employee's gross income. *See id.* § 127(a).

10. Section 125 — Cafeteria Plans;<sup>28</sup>11. Treasury Regulation section 1.117-3(a) — Tuition Reduction Programs.<sup>29</sup>

Before 1984, with the exception of these specific exclusions, there were no statutory provisions that dealt specifically with the tax treatment of fringe benefits. In some cases, such as the provision to employees of free or discounted goods and services sold by the employer, the benefit was treated by employers, employees, and the Internal Revenue Service (IRS) as not giving rise to taxable income.<sup>30</sup> For the majority of nonstatutory fringe benefits, however, there were no clear cut guidelines to determine whether these benefits were taxable. As a result, the question of federal income taxation of nonstatutory fringe benefits has been a troublesome area in tax law.

In 1975, the Treasury Department attempted to remedy this problem by issuing a discussion draft of proposed regulations containing rules for determining when and what types of fringe benefits constituted taxable compensation.<sup>31</sup> These regulations, which would have treated many fringe benefits as taxable income, met with considerable resistance from both Congress and the business community, and were withdrawn in 1976.<sup>32</sup> There-

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28. Nontaxable benefits provided under a cafeteria plan which offers a choice between taxable and nontaxable benefits may be excluded from the employee's gross income. See *id.* § 125(a).

29. Tuition reductions offered to employees (and their spouses and dependents) of educational institutions are not included in the employee's gross income. Treas. Reg. § 1.117-3(a) (1984). This provision was amended by the Tax Reform Act of 1984 ("Act"). I.R.C. § 117(d), [1 Code] FED. TAXES (P-H) 24,330, 24,331-32 (July 18, 1984). For a discussion of the amended section, see *infra* text accompanying notes 157-67.

30. HOUSE REPORT, *supra* note 2, at 1591, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 521.

31. The proposed regulations appear in Fringe Benefits: Notice of Publication of Discussion Draft of Regulations, 40 Fed. Reg. 41,118 (1975) (printed Sept. 5, 1975).

32. The withdrawal appears in Fringe Benefits: Withdrawal of Discussion Draft of Proposed Regulations, 41 Fed. Reg. 56,334 (1976). A Treasury Department News Release dated December 17, 1976 stated that the Treasury Department ended its consideration of fringe benefits as gross income to employees because of problems associated with establishing rules of general applicability with respect to such benefits and because of the costs and complexities involved. Wall St. J., Dec. 20, 1976, at 13, col. 3. On Jan. 15, 1981, the Treasury forwarded a revised discussion draft to the House Ways and Means Committee. This revised draft was not reviewed by the Secretary of the Treasury and was not published in the *Federal Register*. HOUSE REPORT, *supra* note 2, at 1590 n.2, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 520 n.2.

after, Congress passed a series of moratoriums prohibiting the Treasury from issuing final regulations on the income tax treatment of nonstatutory fringe benefits.<sup>33</sup> Although the last extension of the moratorium expired at the end of 1983,<sup>34</sup> the Treasury announced that it would refrain from issuing regulations before the end of 1984.<sup>35</sup>

What began as a temporary measure, designed to give Congress sufficient time to consider the issues before passing legislation, resulted in an eight year moratorium during which Congress prohibited the IRS from providing nationwide guidance on the tax treatment of fringe benefits.<sup>36</sup> Because no guidelines were created during this moratorium, it was often not possible to predict whether a particular financial benefit would be treated as taxable income. Although the broad sweep of section 61 includes all forms of non-cash remuneration, it does not specify when or what types of "fringe benefits" specifically fall within this definition. Since there is no statutory definition of "fringe benefit," the determination of when a particular item of economic benefit constitutes taxable compensation has largely been a matter of judicial interpretation.<sup>37</sup> Given the absence of an ab-

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33. The moratoriums were enacted in the following statutes: (1) Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 3, 92 Stat. 3097 (1978) (codified as amended at 26 U.S.C. § 61 (1978)); (2) Act of October 7, 1978, Pub. L. No. 95-427, § 1, 92 Stat. 996 (1978) (codified as amended at 26 U.S.C. § 61 (1978)), which prohibited the Treasury from issuing, prior to 1980, final regulations under § 61 relating to the income tax treatment of fringe benefits; and (3) Act of December 29, 1979, Pub. L. No. 96-167, § 1, 93 Stat. 1275 (1979) (codified as amended at 26 U.S.C. § 61 (1979) which extended the moratorium through June, 1981).

34. Under the Economic Recovery Act of 1981 the Treasury was prohibited from issuing, prior to January 1, 1984, final regulations under § 61 relating to the income tax treatment of fringe benefits. See Economic Recovery Act of 1981, Pub. L. No. 97-34, § 801, 95 Stat. 172, 349.

35. The Treasury announced that the Treasury and the I.R.S. "will not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985," and that "present administrative practice will not be changed during this period." Treas. Dep't News Release, R-2461 (Dec. 20, 1983), *reprinted in* 1984-4 I.R.B. 31.

36. Parnell, *Congress and the Fringe Benefit Issue*, in TAX INSTITUTE OF AMERICA PROCEEDINGS OF THE SEVENTY-FOURTH ANNUAL CONFERENCE 92 (1981).

37. See, e.g., *Commissioner v. Kowalski*, 434 U.S. 77 (1977) (holding that the "convenience of the employer" requirement of § 119 made it essential to show a business necessity, indicated that the primary purpose standard was applicable to nonstatutory fringe benefits); *United States v. Gotcher*, 401 F.2d 118 (5th Cir. 1968) (allowing taxpayer to exclude amounts paid to him as reimbursements for certain travel expenses);

solute mandate of includability, it is not surprising that most fringe benefits have escaped taxation entirely.

### III. Tax Reform Act of 1984

#### A. General Overview

The following categories of tax-free fringe benefits are provided under section 132, which was added to the Code by the Tax Reform Act of 1984:

1. no-additional-cost services,
2. qualified employee discounts,
3. working condition fringes, and
4. de minimis fringes.<sup>38</sup>In addition, specific exemptions are now available for employee parking, eating facilities, athletic facilities, and qualified tuition reductions provided by the employer.<sup>39</sup>

Only "employees" are eligible to receive the new categories of fringe benefits on a tax-free basis. For purposes of receiving benefits under the exclusions for "no-additional-cost services" and "qualified employee discounts," section 132 defines "employee" as including the following persons:

1. retired and disabled former employees,
2. widows and widowers of former employees who had retired or had become disabled or who died while they were employees, and
3. spouses and dependent or orphan children of employees.<sup>40</sup>The new statutory fringe benefit exclusions do not apply to nonemployees, such as members of a partnership or independent contractors. Therefore, all fringe benefits not expressly excluded

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Challenge Mfg. Co. v. Commissioner, 37 T.C. 650 (1962) (disallowing deduction for yacht expenses); Riss v. Commissioner, 23 T.C.M. 1899 (1964), *aff'd*, 374 F.2d 161 (8th Cir. 1967) (disallowing deduction for car expenses); Walker v. Commissioner, 362 F.2d 140 (7th Cir. 1966) (disallowing deduction for recreational facilities); Cowing v. Commissioner, 28 T.C.M. 696 (1969) (disallowing deduction for travel expenses).

38. HOUSE REPORT, *supra* note 2, at 1593, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 523.

39. These exemptions are effective beginning January 1, 1985. Exemptions relating to qualified tuition reductions are effective for education furnished after June 30, 1985. *Staff Pamphlet*, *supra* note 16, at x-4.

40. I.R.C. § 132(f), [1 Code] FED. TAXES (P-H) 24,353, 24,354 (July 18, 1984). Under § 132(f)(2)(B), a child of divorced parents is treated as the dependent of both parents.



under other Code provisions, and received by members of unincorporated law and accounting firms will apparently now be taxable. Some of these fringe benefits would not be taxable if received by shareholder-employees of professional corporations.

The stated purpose of this legislation was to strike a balance between two competing objectives. First, the new law recognizes that many fringe benefits have customarily been treated as non-taxable.<sup>41</sup> In many industries, employees have traditionally received, either free or at a discount, goods and services which the employer sells to the general public. These benefits have generally not been treated as taxable compensation. Because employers often have valid business reasons, other than compensating employees, for providing these benefits, and because of the administrative difficulties in trying to trace and tax such benefits, codifying these practices as specific statutory exclusions was felt to be appropriate.<sup>42</sup>

Second, the legislation is designed to set out clear guidelines for providing tax-free benefits.<sup>43</sup> The Treasury is expressly authorized to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of the Act."<sup>44</sup> The regulations must be consistent with the language of the Act and its legislative history, including the Conference Report on the final version of the Act and the Ways and Means Committee Report on the original House version of the Act. Thus, if these reports exclude a fringe benefit, it must receive identical treatment in the regulations.<sup>45</sup> For the purposes of assisting both the taxpayers and the IRS, the Treasury is also to issue regulations stating "appropriate and helpful rules" for the valuation of taxable fringe benefits.<sup>46</sup>

The fringe benefits that are excluded from the employee's gross income are also excluded from the employee's wage base

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41. HOUSE REPORT, *supra* note 2, at 1591, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 521.

42. *Id.*

43. *Id.*

44. I.R.C. § 132(k), [1 Code] FED. TAXES (P-H), 24,353, 24,355 (July 18, 1984).

45. CONFERENCE REPORT, *supra* note 4, at 1169, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS, at 1163; HOUSE REPORT *supra* note 2, at 1609, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 539.

46. HOUSE REPORT, *supra* note 2, at 1609, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 539.

for purposes of income tax withholding, social security tax (FICA), unemployment insurance payroll tax (FUTA), and the railroad retirement tax (RRTA). Fringe benefits are excluded from the employee's wage base if, at the time the benefit is provided to, or on behalf of the employee, it is reasonable to believe that the employee will be able to exclude the benefit from income.<sup>47</sup>

Any fringe benefit that does not qualify for exclusion either under section 132 or under another statutory fringe benefit provision of the Code is includable in the employee's gross income for income tax purposes and in wages for employment tax and withholding purposes.<sup>48</sup> Employment tax and withholding provisions of the Code, which were previously applicable to "all remuneration paid in any medium," were amended by the Act to apply to "all remuneration (including benefits) paid in any medium."<sup>49</sup> The time and manner for the collection (or payment) by an employer of employment taxes on non-cash fringe benefits is to be provided in regulations (to be issued).<sup>50</sup>

In general, section 132 does not apply to a fringe benefit if a another Code section expressly provides for the tax treatment of that particular type of benefit.<sup>51</sup> An exception to this rule is the category of "de minimus benefits." A "de minimus" exclusion

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47. I.R.C. §§ 3121(a)(20), 3231(e)(5), 3306(b)(16), 3401(a)(20) (West 1984) amended respectively by Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 531(d)(1), (2), (3), (4), 98 Stat. 494, 884-85.

48. HOUSE REPORT, *supra* note 2, at 1593, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 523.

49. I.R.C. §§ 3121(a), 3306(b), 3401(a) (West 1984), amended respectively by Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 531(d)(1), (3), (4), 98 Stat. 494, 884-85. In the absence of a specific statutory provision to the contrary, the regulations under these employment tax and withholding provisions are to be revised by the Treasury to make clear that remuneration for employment should not be exempt from employment tax merely because the remuneration is paid in the form of property or services rather than cash. HOUSE REPORT, *supra* note 2, at 1609, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 539.

50. I.R.C. § 3501(b) (West 1984), amended by Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 531(d)(5), 98 Stat. 494, 885. To the maximum extent practicable, such regulations may provide for collection (or payment) of FICA taxes on non-cash fringe benefits in a calendar quarter not later than the time for collection (or payment) of such taxes on cash wages paid on the last day of that quarter. The regulations may provide similar rules for other employment taxes. CONFERENCE REPORT, *supra* note 4, at 1170, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 1164.

51. See *supra* notes 16-29 and accompanying text.

may be available even if the benefit received is governed by another section of the Code.<sup>52</sup> For example, under section 129, amounts paid or incurred by an employer to provide dependent care assistance to employees is excludable from the employees' gross income.<sup>53</sup> If the dependent care assistance does not qualify for an exclusion under section 129,<sup>54</sup> amounts expended by the employer may still be excludable as a "de minimus benefit" if the requirements of section 132 are met.<sup>55</sup>

Nondiscrimination is the common thread among the various types of fringe benefits that are now excluded from income. Most fringe benefits may be made available tax-free to employees who are owners, officers, or highly compensated employees, only if the same benefits are provided on substantially equal terms to all other employees. Although the primary reason for the nondiscrimination requirements is fairness, there is also concern that the failure to require nondiscriminatory treatment would exacerbate problems of noncompliance among all taxpayers.<sup>56</sup>

#### B. Section 132(b) No-Additional-Cost Service

A "no-additional-cost service" is defined as a service provided by an employer to an employee for use by such employee, if:

1. the service is ordinarily offered for sale to nonemployees in the line of business in which the employee works;<sup>57</sup> and
2. the employer incurs no substantial additional cost (including foregone revenue) by providing the service to the employee. The cost is to be computed without regard to any amounts paid by the employee for the service.<sup>58</sup>

Generally, the situations in which employers incur no addi-

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52. See I.R.C. § 132(j), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

53. I.R.C. § 129 (West 1984). See *supra* note 26.

54. The day care service will not qualify under the pre-1984 Code if the services are not offered to employees on a nondiscriminatory basis. See I.R.C. § 129(d)(2) (West 1984).

55. HOUSE REPORT, *supra* note 2, at 1608, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 538.

56. *Id.* at 1592, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 522.

57. I.R.C. §§ 132(b)(1), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

58. *Id.* § 132(b)(2) at 24,353.

tional cost by providing services to employees are those in which employees receive the benefit of excess capacity not otherwise purchased by the general public.<sup>59</sup> However, the employer does incur substantial additional cost if other employees spend a substantial amount of time providing a service to the benefited employees.<sup>60</sup> In such a case, the exclusion is not available.

The provision of a no-additional-cost service may be illustrated by the following example. A corporation operates an airline and provides its employees with free travel on a standby basis. This operation qualifies as a no-additional-cost service because: (1) it is provided by the employer to employees who work in the employer's airline line of business; (2) the service is the same as that sold to the public; and, (3) the seats would not have been sold to nonemployees if the employer had not used them. Therefore, the service is provided at no substantial additional cost to the employer.<sup>61</sup> Neither the provision of meals and refreshments to an employee-passenger, nor any extra fuel consumption attributable to the weight of an additional passenger, is considered a substantial additional cost.<sup>62</sup>

Another example of a no-additional-cost service is free or discounted telephone service provided by a telephone company to its employees. Because the phone lines, the switching capacity, and other overhead exist irrespective of the number of calls made, the employees' telephone calls impose no substantial additional cost.<sup>63</sup>

### 1. *The Line of Business Limitation*

An excludable no-additional-cost service must be the same type of service that is sold to nonemployee customers in the ordinary course of the employer's line of business in which the employee works. Services that are primarily sold to employees do not qualify for this exclusion. Because of the line of business limitation, if an employer is engaged in more than one line of

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59. HOUSE REPORT, *supra* note 2, at 1594, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 524.

60. *Id.* at 1594 n.4, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 524 n.4.

61. *Id.* at 1596, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 526.

62. *Id.* at 1596 n.7, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 526 n.7.

63. *Id.* at 1596-97, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 526-27.

business, an employee may receive services on a tax-free basis only from the line of business in which he is employed. For example, an employer that sells airline services and hotel services to the general public is considered to be engaged in two lines of business. Therefore, the employees of the airline may exclude free or discounted airline seats, but may not exclude free or discounted hotel rooms from their taxable income.<sup>64</sup>

For purposes of the line of business limitation, an employer must aggregate all businesses under common control.<sup>65</sup> The aggregated group is then treated as a single employer. If, after aggregating all businesses under common control the products or services sold to nonemployees fall into more than one industry group, this single employer is considered to have more than one line of business.<sup>66</sup>

The line of business limitation was imposed to avoid, to the extent possible, "the competitive imbalances and inequities which would result from giving the employees of a conglomerate or other large employer with several lines of business a greater variety of tax-free benefits than could be given to employees of a

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64. *Id.* at 1594, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 524.

65. The HOUSE REPORT states:

For purposes of section 132, all employees of all corporations that are members of a controlled group of corporations (within the meaning of § 414(b)), all employees of all trades or businesses (whether or not incorporated) under common control § 414(c), or all employees of an affiliated service group § 414(m), are treated as employed by a single employer.

*Id.* at 1607-08, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 537-38 (construing I.R.C. § 132, [1 Code] FED. TAXES (P-H) 24,353, 24,353-55 (July 18, 1984)). For example, if a chain of stores selling identical products separately incorporates each store as a wholly owned subsidiary, the employees of each subsidiary may receive no-additional-cost services or qualified employee discounts from all of the stores in the chain, since they are all in the same line of business. If, however, each store sold different products, the employees could only receive tax-free benefits from the individual store in which they were employed. The rationale behind their rule is if corporations engaged in different businesses under common control are not treated as having a single line of business even though they are treated as one employer. *See id.* at 1607, *reprinted in* 1984 U.S. CODE & CONG. AD. NEWS at 537.

66. The IRS has been instructed to issue regulations to provide guidance to determine whether an employer has two or more separate lines of business. The regulations may take into account the business segments into which corporations divide themselves for financial reporting purposes and may refer to the Standard Industrial Classifications used for other governmental purposes. *Id.* at 1594, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 524.

small employer with only one line of business.”<sup>67</sup> However,

if an employee provides services that directly benefit more than one line of business of the employer, then the individual is treated as performing services in all such lines of business. For example, the chief executive officer, payroll department employees, and similar “headquarters” employees may exclude the value of no-additional-cost services provided by any line of business, if they provide services which directly benefit such lines of business.<sup>68</sup>

Thus, highly compensated “headquarters” employees are likely to receive more tax-free benefits than lower echelon or divisional employees. This not only waters down the nondiscrimination requirements of the statute, but also increases the “competitive imbalances and inequities” of working for a conglomerate,<sup>69</sup> exactly what the drafters of the Act were attempting to prevent.

## 2. *Employer Reciprocal Agreements*

Services provided under reciprocal agreements between employers are also eligible for the no-additional-cost exclusion. A service provided by one employer to an employee of another employer is treated as if it were provided by the employee’s own employer if:

1. the service is provided under a written agreement between the two employers; and
2. neither of the employers incurs any substantial additional cost (including foregone revenue) by providing the service or pursuant to the written agreement.<sup>70</sup>

This rule applies to services provided by unrelated employers,<sup>71</sup> but only if both parties to the agreement provide the same types of services to the general public, and the service is provided in the same line of business in which the recipient employees work. The agreement between the employers must be a reciprocal agreement under which employees of each employer

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67. *Id.* at 1594-95, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 524-25.

68. *Id.*

69. See *infra* notes 117-22 and accompanying text.

70. I.R.C. § 132(g)(2), [1 Code] FED. TAXES (P-H) 24,353, 24,354 (July 18, 1984).

71. For example, another employer not under common control would be considered an unrelated employer. See *infra* notes 117-22 and accompanying text.

may receive the service from the other employer.<sup>72</sup> The criteria for determining whether two unrelated employers are providing the same type of services are the same as those used to determine whether a single employer consists of more than one line of business.<sup>73</sup>

For example, an employee of an airline receives free standby flights under a reciprocal agreement between his employer and another airline. The value of the flight may be excluded from the recipient employee's gross income if it would have been excluded as a no-additional-cost service had it been provided in the same manner by the employee's own employer.<sup>74</sup>

### 3. *Section 4977: The Grandfather Rule*

Section 4977, added to the Code by the Tax Reform Act of 1984, provides an elective grandfather rule which, in certain circumstances, relaxes the line of business limitation requirements for no-additional-cost services.<sup>75</sup> The rule allows the employer to elect that certain employees are to be treated as employed in the line of business in which no-additional-cost services are provided, even though the specified employees are in fact working in a different line of the employer's business.

A prerequisite for making the election is that substantially all of the employees were entitled, on January 1, 1984, to services provided by the employer in one of the employer's business lines.<sup>76</sup> If the election is taken, all employees in another line of the employer's business, which was also in existence on January 1, 1984, are entitled to the no-additional-cost services provided in the line of business in which substantially all employees were entitled to no additional cost services on January 1, 1984. The

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72. HOUSE REPORT, *supra* note 2, at 1594, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 524.

73. *See supra* notes 65-67 and accompanying text.

74. HOUSE REPORT, *supra* note 2, at 1596, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 526.

75. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 531(e), (codified as amended in I.R.C. § 4977, [1 Code] FED. TAXES (P-H) 26,203, 26,203-04 (July 18, 1984)). These rules also apply to the provision of qualified employee discounts. *See infra* text accompanying notes 107-11, 114-16.

76. I.R.C. § 4977(c)(2), [1 Code] FED. TAXES (P-H) 26,203, 26,204 (July 18, 1984).

election applies until it is revoked by the employer.<sup>77</sup> This exception does not apply to services provided under reciprocal agreements between unrelated employers.<sup>78</sup>

Once the election is made, it remains in effect for all future years until it is revoked.<sup>79</sup> During any year in which the election is in effect, the employer is subject to a thirty percent excise tax if the aggregate fair market value of all excludable no-additional-cost services and qualified employee discounts (whether or not excludable pursuant to the grandfather rule) exceed one percent of the total taxable compensation paid to all employees for the year.<sup>80</sup>

#### 4. *The Nondiscrimination Requirement*

No-additional-cost services may be made available to employees who are owners, officers, or highly compensated employees, only if the same benefits are provided on substantially equal terms to all members of a group of employees. A "group of employees" must be defined under a reasonable classification set up by the employer. This classification cannot itself discriminate in

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77. The election applies to the calendar year for which it is made. I.R.C. *Id.* § 4977(d), 26,204. This, however, applies to the first calendar year following the year of election. CONFERENCE REPORT, *supra* note 4, at 1170, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1164.

78. I.R.C. § 4977(c), [1 Code] FED. TAXES (P-H) 26,203, 26,204 (July 18, 1984). For purposes of the elective grandfather rule, all employees of controlled groups of a corporation, *see supra* text accompanying notes 67-69, are treated as employed by a single employer. *Id.* § 4977(e).

79. The election also applies to all subsequent calendar years unless it is revoked by the employer. *Id.* § 4977(d). The election is to be made in a manner to be prescribed by Treasury regulations. A revocation must be made prior to the beginning of the calendar year to which the grandfather rule is not to apply. CONFERENCE REPORT, *supra* note 4, at 1171, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1165.

80. I.R.C. § 4977(a), [1 Code] FED. TAXES (P-H) 26,203, 26,203 (July 18, 1984). The rate of the excise tax is 30% of the remaining excess of the value of these fringe benefits over one percent of aggregate employee compensation. In making this computation, one must take into account: (1) the aggregate fair market value of all excludable no-additional-cost services, and (2) qualified employee discounts (whether or not excludable only pursuant to the grandfather rule) provided by the employer during the calendar year to all its employees. This computation also takes into account all employees in all lines of business of the employer, including lines of business to which the elected grandfather rule does not apply (for instance, a line of business did not exist on Jan. 1, 1984). The amount of tax is not deductible by the employer. CONFERENCE REPORT, *supra* note 4, at 1171, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1165.



favor of the favored group.<sup>81</sup>

The determination of whether a particular classification is reasonable depends on the facts and circumstances involved. A classification that on its face makes the benefits available only to the favored group is per se discriminatory, and no exclusion is available to the recipients of such benefits. However, the reasonableness of a classification will be judged in large part by its effect. That is, by whether: (1) the proportion of officers, owners, and highly compensated employees who benefit is substantially higher than the proportion of other employees who benefit; or (2) the benefits received by officers, owners, and highly compensated employees have a greater value than the benefits received by rank and file employees.<sup>82</sup> It is permissible to provide benefits for certain categories of employees (for example, executives and salespersons) while excluding others, including low-ranking categories (for instance, clerical and maintenance personnel), so long as the proportion of officers, owners, and highly compensated employees receiving benefits within each category is not unduly high.<sup>83</sup> There is no standard provided for determining who will be classified as highly compensated employees.<sup>84</sup>

If the availability of the fringe benefit does not satisfy this nondiscrimination test, the exclusion applies only to those employees (if any) who receive the benefit and who are not members of the favored group. The House Report provides an example:

if an employer offers a twenty percent discount (which otherwise satisfies the requirements for a qualified employee discount) to rank-and-file employees and a thirty-five percent discount to the favored group, the entire value of the thirty-five percent discount

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81. I.R.C. § 132(h)(1), [1 Code] FED. TAXES (P-H) 24,353, 24,354 (July 18, 1984).

82. HOUSE REPORT *supra* note 2, at 1606, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 536.

83. *Id.* at 1607, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 537.

84. "For purposes of the nondiscrimination rule, the determination of which employees are highly compensated would depend on the facts and circumstances of the case, but could rely on Treasury Department guidelines." *Id.* If these guidelines are issued, they may define "highly compensated" employees by one or both of the following methods: (1) an employee with compensation above "a specified percentile in the employer's compensation distribution," (2) an employee with compensation above a specified annual rate. *Id.* These guidelines may vary by industry and reflect unique characteristics of particular employers of particular industry categories of employment. *Id.*

(not just the excess over twenty percent) is includable in gross income . . . of the [favored] group who make purchases at the thirty-five percent discount.<sup>85</sup>

### C. Section 132(c) Qualified Employee Discounts

An "employee discount" is defined as the amount of reduction between the price at which merchandise (consisting of property or services) is offered by the employer to the general public ("the selling price") and the reduced sales price of the merchandise provided to employees.<sup>86</sup> A "qualified" employee discount must only be for "qualified property or services." The discount is "qualified" only to the extent it does not exceed specified statutory limits.<sup>87</sup>

"Qualified property" is defined as personal property or services offered for sale to nonemployee customers in the ordinary course of the line of business in which the employee works. Qualified property does not include real property or personal property that is commonly held for investment,<sup>88</sup> such as securities, gold coins, or interests in mineral producing property, regardless of whether a particular purchase is made for investment purposes.<sup>89</sup>

"Qualified services" are services that are ordinarily offered for sale to nonemployee customers in the line of business in which the employee works.<sup>90</sup> For example, an employee of a brokerage house purchases stock from his employer. The brokerage house gives the employee a discount on the commission it charges the general public. This is a qualified employee discount and is excludable from the employee's gross income. However, any discount allowed on the price of the stock itself is not excludable, because the stock is not qualified property.<sup>91</sup> The sale

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85. *Id.* at 1606, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 536.

86. I.R.C. §§ 132(c)(3), 132(i), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

87. *Id.* § 132(c)(1) at 24,353.

88. *Id.* § 132(c)(4).

89. HOUSE REPORT, *supra* note 2, at 1597, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 527.

90. I.R.C. § 132(c), [1 Code] FED. TAXES, (P-H) 24,353, 24,353 (July 18, 1984).

91. HOUSE REPORT, *supra* note 2, at 1597, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 527.

of life insurance to an employee of an insurance company is also a qualified service, but a loan given by a financial institution to an employee is not.<sup>92</sup> Except for the foregoing examples, neither the Act nor the Committee Reports provide a definition or description of employer-provided benefits that are treated as "services" for purposes of the qualified employee discount.

### 1. *The Gross Profit Percentage Limitation on Qualified Property*

An employee discount on qualified property is excluded from the employee's income only up to a specified limit.<sup>93</sup> The excludable amount of the discount is limited to the "gross profit percentage" of the price for all property sold in the line of business in which the employee is providing service.<sup>94</sup> The gross profit percentage is the excess of the aggregate sales price of all items sold in that line of business (or a reasonable classification of merchandise selected by the employer) over the cost of goods sold.<sup>95</sup> If the discount allowed the employee exceeds the gross profit percentage, the excess discount on the purchase is included in the employee's gross income.<sup>96</sup>

For example, an employer's total sales of merchandise in the line of business in which employees work are \$1,000,000 for the year. The employer's total cost for the merchandise is \$600,000. The gross profit percentage for the year is forty percent (\$1,000,000 minus \$600,000 equals forty percent of \$1,000,000). Employees may receive nontaxable discounts on such merchandise to the extent the discount does not exceed forty percent of the selling price of the merchandise to nonemployee customers.<sup>97</sup>

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92. *Id.* at 1600 n.12, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 530 n.12.

93. I.R.C. § 132(c)(1), [1 Code] FED. TAXES (P-H) 24,353, 24,353 (July 18, 1984).

94. *Id.* § 132(c)(1)(A).

95. *Id.* § 132(c)(2)(A).

96. HOUSE REPORT, *supra* note 2, at 1599, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 529.

97. *Id.* In determining the employer's gross profit percentage, cost is to be computed by the employer in the same manner as the employer computes its federal income tax liability under the inventory rules in I.R.C. § 471, [1 Code] FED. TAXES (P-H), 25,103, 25,103 (July 18, 1984), and the applicable regulations. "[F]or example, a retailer is to use the 'retail method' of pricing inventory under Treas. Reg. § 1.471-8 in computing cost for purposes of the gross profit percentage discount limitation if that is the method used by the employer to value inventory for income tax purposes." HOUSE REPORT, *supra* note 2,

An employer may compute the gross profit percentage on the basis of all merchandise ordinarily offered for sale to customers (including employee customers) in the employer's line of business in which the employee works. As an alternative, the employer may select any reasonable class of merchandise for the computation.<sup>98</sup> For example, a retail department store business may compute a gross profit percentage for the store business as a whole, or may compute different gross profit percentages for different departments or types of merchandise (such as high markup items versus low markup items), provided the classifications are made on a reasonable basis. Under either computation method, the determination of the gross profit percentage is to be made on the basis of the employer's experience during a representative period,<sup>99</sup> such as the prior year.<sup>100</sup>

If an employee discount on qualified property does not exceed the gross profit percentage, there is no dollar ceiling on the excludable amount. Since the calculation of the gross profit percentage is apparently made without regard to labor expenses or indirect costs, very substantial tax-free discounts are available to employees.

## 2. *The Twenty Percent Discount Limitation on Qualified Services*

An employee discount on qualified services is excluded from the employee's gross income up to a specified limit.<sup>101</sup> The discount exclusion for a service is limited to twenty percent of the price at which the services are offered by the employer to non-employee customers.<sup>102</sup> There is no profit percentage limitation. If the discount allowed to the employee exceeds twenty percent, the excess discount on the purchase is included in the em-

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at 1600, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 530 (citing Treas. Reg. § 1.471-8 (1983)).

98. I.R.C. §§ 132(c)(2)(B)(i), 132(i), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

99. *Id.* § 132(c)(2)(B)(ii).

100. HOUSE REPORT, *supra* note 2, at 1600, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 530.

101. I.R.C. § 132(c)(1), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

102. *Id.* § 132(c)(1)(B).

ployee's gross income.<sup>103</sup> Since an insurance policy is considered a qualified service,<sup>104</sup> an exclusion is allowed for a discount of up to twenty percent off the price at which the policy is sold to the general public.

A discounted price may be the price at which a product or service is offered to the public because a discount is regularly provided by the employer in the ordinary course of business, through arrangements negotiated with large groups of consumers (for instance, to all members of professional associations) and because substantial sales are made at a discount under these agreements. This regularly discounted group selling price is the price at which the employee discount is computed. Thus, an employee would have taxable income on a purchase of services at a discount only to the extent that the price charged to the employee was less than eighty percent of the discounted group selling price.<sup>105</sup>

To qualify for the employee discount exclusion, the goods and services on which the discount is made available must be those that are offered for sale by the employer to nonemployee customers in the ordinary course of the employer's line of business in which the employee works. Thus, if most of the goods and services are provided or sold to employees, rather than nonemployee customers, they do not qualify for the exclusion.<sup>106</sup>

### 3. *The Line of Business Limitation*

The rules for treatment of a single employer with more than one line of business are the same as those described in connection with the exclusion for no-additional-cost service.<sup>107</sup> But, the discount exclusion is not available for goods and services provided by another employer, except where commonly controlled businesses are treated as one employer.<sup>108</sup> This is the case

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103. HOUSE REPORT, *supra* note 2, at 1600, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 530.

104. See *supra* text accompanying note 92.

105. HOUSE REPORT, *supra* note 2, at 1600, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 530.

106. *Id.*

107. See *supra* notes 65-66 and accompanying text.

108. See *supra* text accompanying notes 70-71.

whether or not a reciprocal agreement exists.<sup>109</sup>

To qualify for the employee discount exclusion, the goods and services for which the discount is given must be offered for sale to nonemployee customers in the ordinary course of the employer's line of business in which the employee works.<sup>110</sup> Thus, if most of the goods and services are provided or sold to employees, rather than nonemployee customers, they do not qualify for the exclusion.

For example, an employee works for a company that consists of more than one line of business, such as a company consisting of a retail store business, a hotel business, and a manufacturing business. The employee is eligible for the discount exclusion only for property or services offered to customers in the ordinary course of business in the particular line of business in which he works. This is the case regardless of whether the employer makes discounts available to the employees in the other two lines of business. Thus, in the example, employees of the hotel business or of the manufacturing business are not eligible for the discount exclusion on a purchase of merchandise at a discount from the employer's store. On the other hand, employees that provide repair, or financing services for retail merchandise, or that sell retail merchandise through a catalogue are considered as providing services in the retail merchandise line of business and hence can exclude discounts on merchandise items.<sup>111</sup>

There is a special rule that governs employee discount exclusions in leased sections of department stores. If a department store leases floor space to another employer (such as a cosmetic firm), and the employees of the lessee make over-the-counter sales that appear to the public as if they are made by department store employees, then the leased section is treated as part of the line of business of the employer operating the store. Employees of the lessee (cosmetics firm) making the over-the-counter sales are treated as employees of the store. Accordingly, if the cosmetics employees in the leased section receive a quali-

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109. See *supra* note 69.

110. HOUSE REPORT, *supra* note 2, at 1598, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 528.

111. *Id.* at 1598, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 528.

fied discount from the department store on purchases of store merchandise (other than cosmetics), the amount of the discount is nontaxable.<sup>112</sup> The exclusion is not available to other employees of the cosmetics firm who do not engage in over-the-counter sales. In addition, because the leased section is considered part of the department store's line of business, any qualified discount offered to the lessor's employees by the lessee is excluded from income.<sup>113</sup> Thus, a qualified discount given to department store employees by the cosmetics firm to purchase cosmetics in the leased section is nontaxable.

If the primary business of an affiliated group<sup>114</sup> is the operation of retail department stores, and, if on October 5, 1983, the employees of a member of such group were entitled to employee discounts at retail department stores operated by another member of the affiliated group, then the employer of these employees is treated as engaged in the same line of business as the department store operator for purposes of qualified employee discount.<sup>115</sup> The rule does not operate in the reverse direction, so that employees of the department store may not exclude any discounts received on property or services offered by other members of the affiliated group, whether or not such discounts were allowed on October 5, 1983.<sup>116</sup>

#### 4. Section 4977: The Grandfather Rule

Section 4977 provides an elective grandfather rule which, in certain circumstances, relaxes the line of business requirements for qualified employee discounts. The requirements for use of

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112. The discount is subject to the profit percentage limitation. See *supra* text accompanying notes 93-100.

113. HOUSE REPORT, *supra* note 2, at 1601, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 531.

114. The term "affiliated group" is defined for this purpose in I.R.C. § 1504(a) with exceptions enumerated in I.R.C. §§ 1504(b)(1) and (b)(2). See Deficit Reduction Act of 1984, Pub. L. 98-369, § 531(f)(1), 98 Stat. 494, 886.

115. *Id.* § 531(f), 98 Stat. at 886. The requirement that the primary business of the affiliated groups has to be the operation of retail department stores is met if, in the year for which the employees' discount is excluded from gross income, most of the sales of the affiliated group are attributable to the operation of retail department stores. HOUSE REPORT, *supra* note 2, at 1598, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 528.

116. HOUSE REPORT, *supra* note 2, at 1599, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 529.

the grandfather rule are the same as those described in connection with no-additional-cost services.<sup>117</sup>

### 5. *The Nondiscrimination Rule*

A qualified employee discount may only be offered to owners, officers, or highly compensated employees if a substantially similar discount is also available to all members of a "group of employees." A "group of employees" can be defined by the employer under any reasonable classification that does not discriminate against the less favored group.<sup>118</sup> The nondiscrimination rules are the same as those described under no-additional-cost services.<sup>119</sup>

### D. *Section 132(d) Working Condition Fringe*

#### 1. *The Employee Deductibility Test*

The fair market value of any property or services provided to an employee by an employer that qualifies as a "working condition fringe" is excluded from the employee's gross income.<sup>120</sup> The term working condition fringe covers any property or services provided by the employer to the extent that the cost of the property or services would have been deductible by the employee as an ordinary and necessary business expense,<sup>121</sup> or as a depreciation expense,<sup>122</sup> if the employee had paid for the property or services himself.<sup>123</sup>

For example, the fair market value of an employee's use of a company car or airplane for business purposes is excluded from his income as a working condition fringe. The exclusion is permitted because the cost would have been deductible by the employee as a business expense<sup>124</sup> had he used his own car or air-

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117. See *supra* notes 79-83 and accompanying text.

118. I.R.C. § 132(h)(i), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

119. See *supra* notes 81-85 and accompanying text.

120. I.R.C. § 132(a)(3), [1 Code] FED. TAXES (P-H) 24,353, 24,353 (July 18, 1984).

121. An employee can deduct an ordinary and necessary business expense under § 162. I.R.C. § 162 (West 1984).

122. Depreciation expenses are deductible under § 167. *Id.* § 167.

123. I.R.C. § 132(d), [1 Code] FED. TAXES (P-H) 24,353, 24,353 (July 18, 1984).

124. HOUSE REPORT, *supra* note 2, at 1601, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 531.



plane for business purposes. On the other hand, the use of a company car or airplane for personal purposes is not excludable, because similar use would not be deductible by the employee. Similarly, an employer-paid subscription to a business periodical for the employee is a working condition fringe.<sup>125</sup>

Fringe benefits that are provided by an employer primarily for the safety of its employees are excluded from gross income as working condition fringes, if the safety precautions are considered ordinary and necessary business expenses. Therefore, if a business provides a bodyguard or car and driver to an employee for security reasons, the value of the bodyguard or use of the car and driver is treated as a working condition fringe and is not includable in the employee's income.<sup>126</sup> Other examples of working condition fringes are employer expenditures for an employee's on-the-job training or travel. Of course, these expenditures must meet the requirements for deductibility (as ordinary or necessary trade or business expenses).

Working condition fringes are not subject to a nondiscrimination requirement. For example, if an employer, for valid business reasons, makes a bodyguard available only to its executives, the working condition fringe exclusion applies.<sup>127</sup>

## 2. *Product Testing and Evaluation*

The fair market value of the use of consumer goods that are manufactured for sale to nonemployee customers and provided to employees for product testing and evaluation outside the employer's business premises is excluded as a working condition fringe if the following conditions are met:

1. consumer product testing must be an ordinary and necessary business expense of the employer;
2. business reasons indicate that testing must be outside of the employer's business premises;
3. the item is furnished to the employee for testing purposes;

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125. *Id.*

126. *Id.* at 1602, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 532.

127. *Id.* at 1607, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 537. *See also* CONFERENCE REPORT, *supra* note 4, at 1172, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1166.

4. the item is made available to the employee no longer than necessary to test the product;

5. the employer imposes limits on the use of the item that significantly reduces any personal benefit to the employee;

6. the employee must furnish a report to the employer.<sup>128</sup> Presumably, these conditions were imposed to prevent employers from circumventing the fringe benefit rules by giving employees products under the guise of "testing." Although the Committee Report's requirements for exclusion go far beyond anything contained in the statute, they are likely to be reflected in future regulations.

If products are furnished under a testing and evaluation program only to officers, owners, or highly compensated employees, this fact may affect a determination of whether the goods are furnished for testing and evaluation purposes or for compensation purposes. Unless the employer can show a business reason for the classification of employees to whom the products are furnished,<sup>129</sup> the goods may be included in the employee's gross income.<sup>130</sup>

Even if the personal use of consumer goods provided to an employee primarily for product testing and evaluation does not qualify for tax-free treatment under the above requirements, the value of the personal use is excluded from the employee's gross income if the employee pays or reimburses the employer for his personal use.<sup>131</sup>

### 3. *Employer-Provided Parking and Automobiles*

Parking provided to an employee on or near the employer's business premises is treated as a working condition fringe,<sup>132</sup> although the cost of parking would not be deductible by the employee.<sup>133</sup> The fair market value of free or reduced-cost parking

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128. HOUSE REPORT, *supra* note 2, at 1602, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 532.

129. An example of a "legitimate business reason" is an automobile are furnished to its design engineers and supervisory mechanics for testing and evaluation.

130. *Id.* at 1602-03, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 532-33.

131. CONFERENCE REPORT, *supra* note 4, at 1171, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 1165.

132. I.R.C. § 132(h)(4), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

133. See I.R.C. § 162 (West 1984).

is excluded from gross income.<sup>134</sup> The nondiscrimination requirements are not applicable to the provision of employee parking.<sup>135</sup> Therefore, an employer may provide parking only to owners, officers and highly compensated employees without jeopardizing the employee's exclusion.

A special rule governs the use of an automobile for demonstration purposes by a salesperson. If an automobile is provided by an employer to a full-time automobile salesperson for "qualified automobile demonstration use," it is treated as a working condition fringe.<sup>136</sup> Use of the automobile qualifies for an exclusion if:

1. the use of the car is provided primarily for the purpose of facilitating the salesperson's performance of services; and
2. there are substantial restrictions on the employee's personal use of the car.<sup>137</sup>

Finally, the exclusion of qualified auto demonstration use, as a working condition fringe, is limited to full-time automobile salespersons.<sup>138</sup> The exclusion is not available to any other employees, such as part-time salespersons or mechanics.<sup>139</sup>

Thus, if an auto salesperson has a car available to show to customers during working hours and is required to drive a car that his employer sells, the use is an excludable working condition fringe provided the use is properly circumscribed. To restrict the use the employer could place a mileage limitation on the employee, prohibit storing personal items in the car, and prevent the employee from taking the car on vacation. Under these circumstances, the value of use of the car in the geographic sales area qualifies for exclusion.

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134. HOUSE REPORT, *supra* note 2, at 1603, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 533.

135. CONFERENCE REPORT, *supra* note 4, at 1171, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1165.

136. I.R.C. § 132(h)(3)(A), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

137. *Id.* See also HOUSE REPORT, *supra* note 2, at 1603, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 533.

138. HOUSE REPORT, *supra* note 2, at 1603, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 533.

139. CONFERENCE REPORT, *supra* note 4, at 1171, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1165.

## E. Section 132(e) *De Minimis Fringes*

### 1. General Rules

The fair market value of any fringe benefit that qualifies as a "de minimis fringe" is excluded from the recipient's gross income.<sup>140</sup> A "de minimis fringe" is any property or service whose value is so small that accounting for it is unreasonable or administratively impracticable. The Act makes the frequency with which benefits are provided to employees a factor in determining whether the fair market value of the property or service is so small that accounting for the benefits is unreasonable or administratively impracticable.<sup>141</sup> Examples of de minimis fringes include: occasional typing of personal letters by a company secretary; occasional personal use of a company copying machine; company cocktail parties or picnics; dinner money or taxi fare for employees because of overtime work; occasional theatre or sporting event tickets; and coffee and doughnuts furnished to employees.<sup>142</sup>

The provision of an exclusion for de minimis fringes has its roots in pre-1984 law. For example, holiday gifts or property of nominal value, given generally to employees to promote good will, need not be included in the employee's gross income.<sup>143</sup> The cost of the items given to employees may be deducted by employers within specified limits.<sup>144</sup>

The act does not fully explain how or under what circumstances employers are to keep track of fringes to determine whether in any year they are de minimis for an individual employee. The act also does not quantify what a de minimis amount would be, nor state what effect frequency and valuation might have on qualification.

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140. I.R.C. § 132(a)(4), [1 Code] FED. TAXES (P-H) 24,353, 24,353 (July 18, 1984).

141. *Id.* § 132(e)(1).

142. HOUSE REPORT, *supra* note 2, at 1603-04, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 533-34; CONFERENCE REPORT, *supra* note 4, at 1172, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 1166.

143. Gifts may not be made in cash or in property easily converted into cash. Rev. Rul. 59-58, 1959-1 C.B. 17.

144. The cost of gifts up to a limit of \$25.00 per employee per year may be deducted by the employer. I.R.C. § 274(b) (West 1984). See also *Poletti v. Commissioner*, 330 F.2d 818 (8th Cir. 1964); *Hallmark Cards, Inc. v. United States*, 200 F. Supp. 847 (W.D. Mo. 1961).

## 2. *Subsidized Eating Facilities*

Although the value of eating regularly at an employer-provided eating facility may not technically qualify as a de minimis fringe benefit, Congress thought the problems associated with keeping records identifying the employees who ate in the facility on a particular day made it appropriate to exclude the value of the meal from taxable income. The act treats an employer-provided eating facility for its employees as a de minimis fringe if:

1. the facility is located on or near the business premises of the employer; and

2. the revenue derived from the facility normally equals or exceeds the direct operating costs of the facility.<sup>145</sup> When these requirements are met, the excess of the value of subsidized meals provided to an employee, less the amount charged the employee for such meals, is excluded from the employee's income.<sup>146</sup>

The subsidized eating facility exclusion applies only to subsidized meals where the employees reimburse the employer for at least the cost of providing the meals. If free meals are provided or if the employer's costs exceed the amount he receives from employees, this provision does not apply. Under section 119, however, free or subsidized meals provided to employees on the employer's premises are excludable if such meals are provided for the employer's convenience.<sup>147</sup>

The eating facility exclusion has a nondiscrimination requirement. An eating facility will be treated as a tax-free de minimis fringe when provided to an officer, owner, or highly compensated employee only if access to the facility is available on substantially similar terms to all members of a group of employees. The nondiscrimination requirement is therefore the same as that governing no-additional-cost services.<sup>148</sup> Executive dining rooms do not qualify as a tax-free de minimis fringe.<sup>149</sup> But, meals provided to executives in executive dining rooms for

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145. I.R.C. § 132(e)(2), [1 Code] FED. TAXES (P-H) 24,353, 24,354 (July 18, 1984).

146. HOUSE REPORT, *supra* note 2, at 1604, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 534.

147. I.R.C. § 119(a) (West 1984).

148. See *supra* text accompanying notes 81-85.

149. I.R.C. § 132(e)(2), [1 Code] FED. TAXES (P-H) 24,353, 24,353-54 (July 18, 1984).

the employer's convenience (for example, to enable such persons to be "on call" during meal times) could, however, still be excluded under section 119, because section 119 does not have a nondiscrimination requirement.<sup>150</sup>

The nondiscrimination rule applies only to subsidized eating facilities and is not applicable to other de minimis fringes. Therefore, the exclusion for de minimis fringes is available even if these fringes (excluding eating facilities) are provided in a manner which discriminates in favor of employees who are officers, owners, or highly compensated employees.<sup>151</sup>

#### F. Section 132(h)(5) Athletic Facilities

The fair market value of any on-premises athletic facilities<sup>152</sup> provided by an employer to his employees, is excluded from the employee's gross income.<sup>153</sup> Any athletic facility located on the employer's premises and operated by the employer qualifies for the exclusion if the facility is used primarily by employees or by their spouses and dependent children. The athletic facility need not be in the same location as the employer's business premises. However, it must be located on non-residential use premises which are owned and operated by the employer.<sup>154</sup>

The nondiscrimination requirements of section 274(e)(5), rather than section 132, apply to the exclusion for on-premises athletic facilities. Section 274(e)(5) allows a deduction to an employer who provides athletic facilities to employees, only if the facilities are not provided exclusively for the benefit of owners, officers, and highly compensated employees.<sup>155</sup>

The exclusion for employer-provided athletic facilities is not available for employer-paid memberships in a country club or similar facility unless the facility itself is owned and operated by

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150. I.R.C. § 119 (West 1984).

151. HOUSE REPORT, *supra* note 2, at 1607, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 537.

152. On-premises athletic facilities include gyms, swimming pools, and tennis courts. *Id.* at 1605, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 535.

153. I.R.C. § 132(h)(5)(A), [1 Code] FED. TAXES (P-H) 24,353, 24,355 (July 18, 1984).

154. HOUSE REPORT, *supra* note 2, at 1607, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 535.

155. I.R.C. § 274(e)(5) (West 1984); Treas. Reg. § 1.274-2(f)(2)(v) (1984).

the employer and satisfies the requirements for exclusion. If no exclusion is available, the fair market value of the club membership is includable in the employee's gross income.<sup>156</sup> Although no reason is given for this limitation, presumably it is to prevent employees from receiving expensive memberships, on a tax free basis, in clubs that are not used primarily for athletic purposes.

#### G. Section 117(d) Qualified Tuition Reduction

Amounts received as "qualified tuition reductions," are excluded from the gross income of employees of educational institutions.<sup>157</sup> The Act provides for two categories of tuition reduction: undergraduate and graduate education.

The first category applies only to tuition for education at the elementary, secondary, or undergraduate level. It applies whether the tuition reduction is for education obtained at the employer's educational institution, or another educational institution.<sup>158</sup> The education for which the tuition reduction is provided must be either the employee's own education,<sup>159</sup> or that of a person treated as an employee.<sup>160</sup> Thus, a qualified tuition reduction may be provided for the education of:

1. active, retired and disabled employees;
2. spouses of such employees; and
3. surviving spouses and dependent or orphan children of

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156. HOUSE REPORT, *supra* note 2, at 1605, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 535.

157. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 532(a), (codified in I.R.C. § 117(d), [1 Code] FED. TAXES (P-H) 24,330, 24,331 (July 18, 1984)). This new provision supercedes Treas. Reg. § 1.117-3(a) (1983), the pre-1984 provision relating to tuition remissions. A qualifying educational institution is defined in I.R.C. § 170(b)(1)(A)(ii), [1 Code] FED. TAXES (P-H) 24,476, 24,477 (July 18, 1984), effective for education furnished after June 30, 1984. HOUSE REPORT, *supra* note 2, at 1604-05, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 534-35.

158. I.R.C. § 117(d)(2), [1 Code] FED. TAXES (P-H) 24,330, 24,331 (July 18, 1984). The employer must be an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. *Id.* § 170(b)(1)(A)(ii), at 24,476-77. The tuition reduction must be provided either in connection with education at the educational institution that is the employer or at another educational institution which has the same characteristics, described above, as the employer. *Id.* § 117(d)(2), at 24,331.

159. *Id.* § 117(d)(2)(A).

160. *Id.* § 117(d)(2)(B).

such employees.<sup>161</sup>

The second category of tuition reduction exclusion applies to tuition reductions for graduate education. The education may be obtained only at the employer's educational institution and is only available if the employee is a teaching or research associate, or an assistant at that institution. The exclusion is not available for tuition reduction on the graduate level provided to a former employee, or the spouse or dependents of a current or former employee.<sup>162</sup> Tuition reductions at the graduate level are eligible for exclusion as scholarships if they satisfy the applicable requirements.<sup>163</sup>

A qualified tuition reduction is excludable from the gross income of an employee only if a tuition reduction is made available to employees on a nondiscriminatory basis. The tuition reduction must be made available on substantially the same terms to each member of a group of employees that has been defined under a reasonable classification, set up by the employer, which does not discriminate in favor of officers, owners, or highly compensated employees.<sup>164</sup> The Act does not indicate who qualifies as an "owner" of an educational institution.

If an educational institution provides tuition reductions only to faculty members and their spouses and dependents, this limitation will not violate the Act's nondiscrimination rule if the benefit is provided on substantially the same terms to each member of this employee class (for example, faculty members). But if the benefit is provided on more favorable terms to faculty members who are officers (for example, the president or dean) of the educational institution or to faculty members who are more highly compensated (for example, tenured professors) than other instructors, then the tuition reduction provided to such officers or highly compensated faculty members would not be excludable from their gross income.<sup>165</sup>

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161. *Id.* § 132(f), at 24,354.

162. HOUSE REPORT, *supra* note 2, at 1605, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 535.

163. CONFERENCE REPORT, *supra* note 4, at 1173, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 1167.

164. I.R.C. § 117(d)(3), [1 Code] FED. TAXES (P-H) 24,330, 24,331 (July 18, 1984).

165. CONFERENCE REPORT, *supra* note 4, at 1173, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 1167.



The Act also provides a moratorium, effective during 1985, on the issuance of regulations providing for the taxability of "qualified campus lodging" furnished after December 31, 1983, and before January 1, 1986.<sup>166</sup> Qualified campus lodging is defined as lodging located on or near a campus of an educational institution, which is provided to an employee of the institution, or to the spouse or dependents of the employee.<sup>167</sup> The moratorium assures that campus lodging provided by colleges to faculty members in 1984 and 1985 at below cost will not be taxed, but it leaves open the possibility that the value of subsidized housing will subsequently be taxable to the extent that it is provided for less than its actual cost or fair market value.

#### IV. Valuation of Taxable Benefits

Although section 132 is quite comprehensive, it is clear that not every employer-provided fringe benefit will qualify for tax-free treatment. Any fringe benefit that does not qualify for exclusion under section 132, or under another specific fringe benefit provision of the Code, is includable in the employer's gross income at the excess of its fair market value over any amount paid by the employee for the benefit.<sup>168</sup>

Although the basic tests for includability are clear, the amount to be included is not clear, as no guidance on how to calculate the fair market value of a fringe benefit is provided.<sup>169</sup> There are various methods by which the "fair market value" of an item can be determined.<sup>170</sup> These valuation methods include: the employer's cost in providing the benefit; the price charged

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166. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 531(g)(1), 98 Stat. 494, 886.

167. *Id.* § 531(g)(2), 98 Stat. at 886.

168. HOUSE REPORT, *supra* note 2, at 1609, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 539.

169. A 1981 Treasury discussion draft of proposed fringe benefit regulations addressed the valuation issue, but this section was not included in the 1984 Act. *Id.* at 1590, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 520. In § 1.61-20 of the draft, the fair market value is defined as the amount that the employee would have had to pay for the benefit in an arm's length transaction. That is, the market price commonly charged for similar services or products. *Treasury Department Discussion Draft of Proposed Income Tax Regulations on Fringe Benefits*, DAILY TAX REP., No. 11, at J-14 (Jan. 16, 1984).

170. See Wasserman, *supra* note 12, at 153.

by the employer to customers for the same product or service; the price commonly charged for similar products or services; the benefit's resale value to the employee; or the benefit's "actual" value to the employee. Use of different methods for determining the "fair market value" could yield significantly different amounts. For example, the resale value of property sold by an individual, even if unused, is generally substantially less than the retail value for the same item.

A benefit that is provided to an employee gratuitously, or at a reduced price by the employer, may often be worth less to the employee than its retail value. The employee may feel obligated to accept the benefit from his employer even though he would not have purchased the same service or product at its fair market value. The employer may impose restrictions on the receipt of the benefit, such as making the benefit available only at specified times during a year, or by offering a limited selection as to model or color. The employee may accept the benefit, even though its value would later be taxable, because it in effect constitutes an interest free loan between the time the item is received and the time taxes are paid.

According to the House Report, "the Treasury is to issue regulations setting forth appropriate and helpful rules for the valuation of taxable fringe benefits."<sup>171</sup> Given the Treasury's prior position on this issue,<sup>172</sup> it is likely that the regulations will require the inclusion of taxable fringe benefits in the recipient's gross income at their retail value.

## V. Conclusion

The stated purpose of the Act is to establish well-defined boundaries for providing tax-free benefits. The Act is designed to eliminate the "inequities, confusion and administrative difficulties" that resulted from the moratorium on the promulgation of fringe benefits regulations.<sup>173</sup> Although the Act goes a long way in establishing guidelines and will undoubtedly exert con-

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171. HOUSE REPORT, *supra* note 2, at 1609, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 539.

172. See *supra* note 169.

173. HOUSE REPORT, *supra* note 2, at 1592, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 522.

siderable influence on what types of fringe benefits are provided in the future, it creates its own inequities, confusion, and administrative difficulties.

This is particularly true in the "line of business" rules, which turn a basically simple provision into a maze of unnecessary complexity. Despite the antidiscrimination provision, large employers will be able to design fringe benefit programs that effectively favor high-ranking officers. For example, an employer with several lines of business can provide an entire range of fringe benefits to its headquarter's executive officers and related staff because the fringe benefits can be made available to all members who are related to the "lines of business." In contrast, divisional employees of the same employer can only receive selective fringe benefits because they are restricted by their narrower "line of business."<sup>174</sup>

As a result of the on-premises limitation for the exclusion of employer-provided athletic facilities, only employers who are large, wealthy, and located mainly in suburban areas will be able to provide tax-free athletic facilities to their employees. Employers without the space<sup>175</sup> or the means to build in-house facilities are precluded from purchasing memberships in nearby health clubs that provide their employees with the same benefits.<sup>176</sup>

The exclusion for both employer furnished parking and eating facilities allows them to be located either on or near the employer's premises. This was presumably allowed because many employers could not provide parking or eating facilities on their own premises but could lease such facilities from others in the area. There is very little reason why this same type of provision cannot also be made for athletic facilities, with adequate safeguards to prevent abuse. For most employers, the provision of in-house athletic facilities is a major undertaking. It is clearly cheaper, and much more sensible, to simply permit employers to purchase memberships for their employees in existing athletic clubs, even if the employers have the means to provide on-premises facilities.

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174. *Id.* at 1594-95, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 524-25.

175. Most urban employers do not have enough room to provide a gym to their employees.

176. See *supra* text accompanying notes 152-54.

The language of section 132 is inclusive enough to leave little room for arguing that any fringe benefit which does not fall within the statutory exception is excludable. The legislative history indicates that the drafters were well aware that the economic benefits conferred by the new exclusions are exceptions to the general rule of taxability.<sup>177</sup> There is, however, a vast difference between finding items to be taxable and, because of the administrative difficulties involved, actually collecting the tax. It is expected that the provisions of the Act will have no significant revenue effect.<sup>178</sup> Increasing the present income tax base was not the Act's purpose. Instead, the Act serves to codify existing practices under which employers provide their own services tax-free to a broad group of employees.<sup>179</sup> In addition, it serves to provide specifically for the taxation of benefits not explicitly excluded because of the concern that, without statutory guidelines, the increased use of non-cash compensation would result in the significant reduction of the income tax base.<sup>180</sup> For this reason and the fact that employers' costs in providing fringe benefits are deductible if they constitute ordinary and necessary business expenses, it can be expected that the provisions of section 132 will be narrowly construed.

Unfortunately, neither the Act nor the legislative history define what constitutes a "fringe benefit," although the Act seems designed to apply to anything of value received by an employee from an employer. Although the Act purports to offer broad guidelines as to when a fringe benefit is, or is not taxable, it may still be necessary to resort to the courts to determine if and when there is a "fringe benefit" at all.

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177. See *supra* notes 5-10 and accompanying text.

178. HOUSE REPORT, *supra* note 2, at 1610, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 540.

179. *Id.*

180. *Id.* at 1592, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 522.

## Addendum

### *Temporary Regulations Issued — January 7, 1985*

#### I. General Overview

After this article was written, the Internal Revenue Service (the "Service") issued proposed and temporary regulations on the treatment of taxable and nontaxable fringe benefits, pursuant to the Tax Reform Act of 1984.<sup>181</sup> The temporary regulations, drafted in question and answer format and effective as of January 1, 1985, provide examples of taxable and nontaxable fringe benefits, rules for determining who is taxed for the value of a fringe benefit, and general rules for the valuation of taxable fringe benefits.<sup>182</sup> Regulations in these areas were urgently needed because the Act requires inclusion of taxable non-cash benefits in the gross income of recipients after January 1, 1985, but makes no provision on how these benefits should be valued.

The temporary regulations also provide optional special valuation rules for personal use of employer-provided automobiles, use of such automobiles solely for commuting, personal travel on employer-provided airplanes, and free or discounted flights on commercial airlines not excludable under section 132 as a no-additional-cost benefit.<sup>183</sup> These special rules are intended to limit disputes between taxpayers and the Service over the valuation of applicable fringe benefits. The rules proscribe amounts and formulas, known as "safe harbors," that the Service will accept without challenge. These special valuation rules, when properly applied, may be relied upon to determine income inclusion, withholding, and reporting, in lieu of determining the actual fair market value of the fringe benefit.<sup>184</sup>

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181. Taxation of Fringe Benefits, T.D. 8004, 50 Fed. Reg. 747 (1985) (proposed Jan. 7, 1985) [hereinafter cited as Temp. Regs.].

These temporary regulations were formulated and released to serve as the basis for adopting final regulations. Public comment is being collected. Consideration will be given to any written commitments submitted to the Commissioner of Internal Revenue by March 8, 1985. Taxation of Fringe Benefits; Proposed Rulemaking, 50 Fed. Reg. 836, 836-37 (1985). The temporary regulations remain in effect until superceded by final regulations. Temp. Regs., *supra*, at 747.

182. Temp. Regs., *supra* note 181, at 747.

183. *Id.* at 748 (summarizing I.R.C. § 61).

184. *Id.*

The regulations also provide guidance on the definition and application of the working condition fringe exclusion, the elective grandfather clause applicable to the exclusions for no-additional-cost benefits, qualified employee discounts, and the discrimination rules under section 132.

According to the new rules, employers are required to withhold income and Social Security taxes on taxable fringe benefits at a flat twenty percent rate at least once each quarter. These benefits are considered "intermittent" income and are not subject to the progressive withholding rates applicable to supplemental pay, such as overtime. When an employer furnishes a non-cash fringe benefit during a calendar quarter, he may consider the benefit to be provided no later than the last day of the calendar quarter. Fringe benefits provided in the first quarter of 1985 may be deemed to be provided in the second quarter of 1985. To give employers time to gear up, withholding is not required until July 1, 1985.<sup>185</sup>

## II. Temporary Regulations Section 1.61-2: Taxable Fringe Benefits

### A. *In General*

Section 61(a)(1), as amended by the Tax Reform Act of 1984, provides that gross income includes all compensation for services, including fringe benefits. Examples of taxable fringe benefits provided in the temporary regulations include an employer-provided automobile, a flight on an employer-provided commercial airplane, an employer-provided vacation, an employer-provided discount on property or services, an employer-

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185. The temporary regulations add the following new regulations covering the technical rules relating to income and Social Security tax withholding:

(a) Question and answer relating to the definition of wages in section 3121(a). *See* Temp. Reg. § 31.312(a)-1.

(b) Question and answer relating to the definition of compensation in section 3231(e). *See* Temp. Reg. § 31.3231(e)-2.

(c) Question and answer relating to the definition of wages in section 3306(b). *See* Temp. Reg. § 31.3306(b)-1.

(d) Question and answer relating to the definition of wages in section 3401(a). *See* Temp. Reg. § 31.3401(a)-1.

(e) Question and answer relating to the time employers must collect and pay the taxes on noncash fringe benefits. *See* Temp. Reg. § 31.3501(a)-1.

provided membership in a country club or other social club, and an employer-provided ticket to an entertainment event.<sup>186</sup> Nevertheless, a fringe benefit, including those outlined above, may be excluded from the recipient's gross income under a specific statutory provision of the Code.<sup>187</sup> For example, an employer-provided ticket to an entertainment event may be excludable under section 132(a)(4) as a *de minimis* fringe.<sup>188</sup>

If the tax treatment of a particular fringe benefit is provided for in another section of the Code, then section 61 and its regulations apply only to the extent that they are consistent with another section.<sup>189</sup> For example, since section 79 provides an exclusion from gross income of \$50,000 worth of group-term life insurance provided to an employee, this amount is excludable from the recipient's gross income even though it would be includable under the general rule of section 61. However, many fringe benefits specifically addressed by other sections of the Code are excludable only to the extent they do not exceed certain limits or only to the extent certain other requirements are met. If the limits are exceeded, or the requirements are not met, some or all of the value of the fringe benefit may be includable in the recipient's gross income under section 61.<sup>190</sup> If, for example, an employee received \$100,000 worth of group-term life insurance, the value of the \$50,000 worth of insurance would be excludable under section 79, and the value of the additional \$50,000 would be includable under section 61.

The value of a fringe benefit is included in the gross income of the "recipient" of the fringe benefit.<sup>191</sup> The "recipient" is deemed to be the person performing the services in connection with the fringe benefit that is provided, irrespective of who actually receives the benefit.<sup>192</sup> Thus, if a fringe benefit is provided to any person in connection with the performance of services by another person, the value of the fringe benefit is included in the gross income of the person who performed the services. This, for

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186. Temp. Regs. *supra* note 181, Question & Answer No. 1, at 749.

187. *Id.*

188. See *supra* notes 140-56 and accompanying text.

189. Temp. Regs., *supra* note 181, Question & Answer No. 2, at 749.

190. *Id.*

191. *Id.* Question & Answer No. 3.

192. *Id.*

example, would prevent an employee from avoiding taxation by having his employer provide taxable fringe benefits to the employee's child rather than directly to the employee.

### B. *Valuation of Taxable Fringe Benefits*

The recipient of a taxable fringe benefit must include in his gross income the amount by which the fair market value of the benefit exceeds the sum, if any, paid for the benefit, and the amount, if any, excludable by some other section of the Code.<sup>193</sup>

Neither the recipient's subjective perception of the value of the fringe benefit,<sup>194</sup> nor the cost incurred by the employer who provided the fringe benefit,<sup>195</sup> is taken into account to determine the fair market value. Nevertheless, if a fringe benefit is provided pursuant to a statutory exclusion phrased in terms of the employer's cost, section 61 does not require the inclusion of the difference between the fair market value and the excludable cost, even if the fair market value is higher.<sup>196</sup> For example, section 129 excludes from an employee's gross income the amount paid or incurred by an employer to provide dependent care assistance to employees, subject to certain limitations. Assuming the amount paid or incurred are within the statutory limits, the excess is not subject to inclusion under section 61, even if the fair market value of the dependent care assistance exceeds the employer's cost. If the cost exclusion is subject to a statutory limit, however, and the employer exceeds that limit in providing the benefit, then the fair market value attributable to any excess cost is subject to inclusion under section 61.<sup>197</sup>

The fair market value of a particular fringe benefit is determined by all of the "objective" facts and circumstances of the particular situation.<sup>198</sup> A "facts and circumstances" test is generally difficult to apply, and is particularly so in this case because the regulations do not delineate what particular facts and circumstances are considered relevant or adequate. This type of

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193. *Id.* Question & Answer No. 5.

194. *Id.* Question & Answer No. 6.

195. *Id.* Question & Answer No. 7, at 749-50.

196. *Id.*

197. *Id.*

198. *Id.* Questions & Answers Nos. 1, 6, at 749.



test will invariably lead to disputes between taxpayers and the Service concerning the valuation of fringe benefits, since the market price of any particular item can vary greatly, even within a small geographic area. For example, what if an employer provides his employees with free radios that sell at the local department store for fifty dollars, and at the local discount store for thirty-nine dollars: which amount constitutes the "fair market value" of the radio?

In valuing benefits, it seems totally unreasonable not to allow use of the employer's cost as the amount includable in the employee's gross income. Use of the employer's cost would be the most equitable, simplest, and least administratively burdensome method of valuing all types of fringe benefits provided to taxpayers. This method would also provide the simplest and most accurate means of verification for the Service. If, for example, an employer provided all of his employees with automobiles for their personal use, and purchased the automobiles at a quantity discount, it seems rather inequitable not to allow the employee to value the benefit at the discounted price rather than requiring him to value it at the rather nebulous "fair market value." This is especially true because the employee may not have chosen the make or model of the automobile the employer purchased. If the employer's cost were an available method for the valuation of all types of fringe benefits, some of the rather complex special valuation rules provided in the temporary regulations could be eliminated.

### *C. Special Rules for Valuation of Taxable Fringe Benefits*

The temporary regulations provide special optional rules for valuing personal use of employer-provided automobiles, use of these automobiles solely for commuting, personal travel on employer-provided airplanes, and nonexcludable free or discounted flights on commercial airlines.

These special rules may be used either by the employer or the employee for income, employment tax, and reporting purposes. Neither the employer nor the employee is bound by the other's decision to use a special rule. However, if a special rule is used by either the employee or employer, certain consistency re-

quirements apply.<sup>199</sup>

### 1. *Employer-Provided Automobiles*

If an employer provides an employee with an automobile strictly for business use, the value of the automobile is excludable from the employee's gross income as a working condition fringe under section 132(a)(3).<sup>200</sup> However, the value of any personal use of the automobile by the employee is taxable under section 61. Under the special rule, if an employer provides an employee with an automobile<sup>201</sup> for personal use during an entire calendar year, the "annual lease value" of the automobile is the value of the benefit includable in the employee's gross income.<sup>202</sup>

When the special rule is not used, the value of an employer-provided automobile is determined under the general valuation rules. Such a valuation must be determined by the cost of renting or leasing a comparable automobile on comparable terms for a comparable period. The value may not be determined by using a cents-per-mile rate applied to the number of miles the automobile is driven.<sup>203</sup>

The annual lease value is calculated by first determining the fair market value of the automobile, without regard to any group or volume discount, as of the first day it is made available to the employee for personal use. The Annual Lease Value is the value in column 2 of the table set forth below, corresponding to the dollar range in column 1 in which the fair market value falls.<sup>204</sup>

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199. *Id.* Question & Answer No. 9, at 750.

200. *See supra* notes 120-39 and accompanying text.

201. "The term 'automobile' means any four-wheeled vehicle which is manufactured primarily for use on public streets, roads and highways." Temp. Regs., *supra* note 181, Question & Answer No. 11, at 750. Note that this Question & Answer has been amended to include a definition of the term "road vehicle." Amended Temp. Regs., *infra* note 277, Question & Answer No. 11, at 7041. *See infra* note 278 and accompanying text.

202. *Id.* Question & Answer No. 12, at 750.

203. *Id.*

204. *Id.* Question & Answer No. 13.

ANNUAL LEASE VALUE TABLE<sup>205</sup>

Automobile fair market value	Annual lease value
(1)	(2)
\$0 to 999 .....	\$600
1,000 to 1,999 .....	850
2,000 to 2,999 .....	1,100
3,000 to 3,999 .....	1,350
4,000 to 4,999 .....	1,600
5,000 to 5,999 .....	1,850
6,000 to 6,999 .....	2,100
7,000 to 7,999 .....	2,350
8,000 to 8,999 .....	2,600
9,000 to 9,999 .....	2,850
10,000 to 10,999 .....	3,100
11,000 to 11,999 .....	3,350
12,000 to 12,999 .....	3,600
13,000 to 13,999 .....	3,850
14,000 to 14,999 .....	4,100
15,000 to 15,999 .....	4,350
16,000 to 16,999 .....	4,600
17,000 to 17,999 .....	4,850
18,000 to 18,999 .....	5,100
19,000 to 19,999 .....	5,350
20,000 to 20,999 .....	5,600
21,000 to 21,999 .....	5,850
22,000 to 22,999 .....	6,100
23,000 to 23,999 .....	6,350
24,000 to 24,999 .....	6,600
25,000 to 25,999 .....	6,850
26,000 to 27,999 .....	7,250
28,000 to 29,999 .....	7,750
30,000 to 31,999 .....	8,250
32,000 to 33,999 .....	8,750
34,000 to 35,999 .....	9,250
36,000 to 37,999 .....	9,750
38,000 to 39,999 .....	10,250
40,000 to 41,999 .....	10,750
42,000 to 43,999 .....	11,250
44,000 to 45,999 .....	11,750
46,000 to 47,999 .....	12,250

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205. This table is found in the temporary regulations. See *id.*

Automobile fair market value	Annual lease value
(1)	(2)
48,000 to 49,999.....	12,750
50,000 to 51,999.....	13,250
52,000 to 53,999.....	13,750
54,000 to 55,999.....	14,250
56,000 to 57,999.....	14,750
58,000 to 60,999.....	15,250

For vehicles that have a fair market value in excess of \$60,000, the Annual Lease Value is equal to: (.25 x automobile fair market value) + \$500.<sup>206</sup>

If the employer transfers the automobile from one employee to another employee for bona fide business reasons, the employer may redetermine the annual lease value based upon the fair market value of the automobile on January 1 of the year of transfer. The annual lease value may not be redetermined if the purpose of the transfer was to reduce federal taxes.<sup>207</sup>

Maintenance of and insurance for an employer-provided automobile,<sup>208</sup> but not employer-provided fuel<sup>209</sup> or other services, such as a chauffeur,<sup>210</sup> are included in determining the annual lease value. The provision of fuel in kind may be valued separately at fair market value based upon all the facts and circumstances, or in the alternative, it may be valued at 5.5 cents per mile for all miles driven by the employee.<sup>211</sup> The services the employer provides for the automobile must be valued separately at fair market value. The valuation is based upon all the facts and circumstances.<sup>212</sup> The special rule may only be used to value an automobile if the automobile is physically located in the United States for substantially all of the calendar year.<sup>213</sup>

The special rule may be used to value an employer-provided

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206. *Id.*

207. *Id.* at 751.

208. *Id.* Question & Answer No. 14, at 751.

209. *Id.* Question & Answer No. 15.

210. *Id.* Question & Answer No. 16.

211. *Id.* Question & Answer No. 15.

212. *Id.* Question & Answer No. 16.

213. *Id.* Question & Answer No. 17.

automobile that is available to the employee for less than an entire calendar year, subject to the following conditions:

(a) For periods of continuous availability of at least 30 days, the value is determined by using a pro-rated annual lease value, computed by multiplying the annual lease value by a fraction, the numerator of which is the number of days of availability and the denominator of which is 365.

(b) For periods of less than 30 days, the Daily Lease Value is used. The Daily Lease Value equals the annual lease value multiplied by a fraction, the numerator of which is four times the number of days of availability and the denominator of which is 365.

(c) A pro-rated annual lease value may be used instead of the Daily Lease Value, by treating the automobile as if it had been available for 30 days, if to do so would result in a lower valuation than using the Daily Lease Value.<sup>214</sup>

The pro-rated annual lease value may only be used if the automobile is not available to the employee for any period of the calendar year because of bona fide business reasons of the employer. The fact that an automobile is unavailable because the employee is on vacation is not a bona fide business reason. For example, an automobile is available to an employee for ten months of the year. It is not available for the two months the employee is on vacation. If the annual lease value is used, it must be used for the entire twelve-month period, and may not be pro-rated to take into account the two-month period of unavailability.<sup>215</sup> However, if the automobile were unavailable for two months because the employer needed to use it in his business, then the pro-rated annual lease value could be used for the ten months that it was available to the employee.

Either the employer or the employee may use the special rule. If the special rule is used by the employer, the employee may use it only if such use is consistent with the employer's use. That is, both the employer and the employee must both use the same annual lease value. Once the special rule is adopted by an employer or employee, the rule must be used for all years in which the automobile is available for personal use. An employee may only use the special rule if it is originally used in the first

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214. *Id.* Question & Answer No. 18.

215. *Id.*

calendar year in which the automobile was made available.<sup>216</sup> He may not use the general valuation rules the first year and subsequently switch to the special rule.

## 2. *Use of Employer-Provided Automobiles for Commuting*

The temporary regulations provide a special rule to value employer-provided automobiles that are not available for personal use other than for commuting. The special rule may only be used to compute the value of commuting if the following criteria are met:

(a) For bona fide, noncompensatory business reasons, the employer requires the employee to commute in the automobile,

(b) The employer's policy is that the employee is not allowed to use the automobile for personal purposes other than commuting,

(c) Except for de minimis use, the employee does not use the automobile for any personal purpose other than commuting,

(d) The automobile is used in the employer's business,

(e) Except in the case of police, fire, and emergency medical vehicles, a substantial amount of the use of the automobile in the employer's business is by employees other than the employee required to use the automobile for commuting, and

(f) The employee required to use the automobile for commuting is not a key employee . . . any employee who is a 5% owner or officer of the employer.<sup>217</sup>

If these requirements are satisfied, the commuting is valued at a flat rate of four dollars per day for each day the automobile is used for commuting. The flat rate applies to either a one-way or a round-trip commute.<sup>218</sup>

Use of this special rule is optional for both the employer and the employee. However, for any calendar year, adoption of the special rule by either the employer or the employee must be

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216. *Id.* Question & Answer No. 19.

217. *Id.* Question & Answer No. 20, at 751-52. This has been amended in part by substituting the words "road vehicle" for the word "automobile." Amended Temp. Regs., *infra* note 277, Question & Answer No. 20, at 7041. See *infra* note 278 and accompanying text.

218. *Id.* Question & Answer No. 21, at 752. This has been amended by substituting the words "road vehicle" for the word "automobile." Amended Temp. Regs., *infra* note 277, Question & Answer No. 21, at 7041. See *infra* note 278 and accompanying text.

made with respect to all commuting in the calendar year that qualifies for use of the special rule.<sup>219</sup>

By providing a "safe harbor" for the use of employer-provided automobiles for commuting, the drafters have taken a simple and equitable rule and complicated it by using criteria that, for many taxpayers, entirely eliminates its use. If the employee is being taxed on the value of being provided an automobile to commute, what possible difference does it make why the employer is offering this benefit or whose automobile he is using? The administrative requirements of the rule are burdensome enough without the special criteria that must be met to use the special rule. It would make more sense to have a rule whose only restriction is that the employee not be allowed to use the automobile for personal purposes other than commuting.

### 3. *Valuation of Flights on Employer-Owned Non-Commercial Airplanes*

If an employee flies on his employer's airplane for personal purposes, the value of the flight is includable in his gross income under section 61. Under the special rule,<sup>220</sup> valuation of the flight depends on (1) whether the flight is provided to a "key employee," and (2) the purpose of the airplane's flight without regard to the employee's purpose.

Multiples of the applicable Standard Industry Fair Level ("SIFL") rates are used to value the flight by applying the following formula: Applicable SIFL Multiple  $\times$  "\$.1480 per mile for first 500 miles, \$.1128 per mile for miles between 501 and 1500 miles, and \$.1085 per mile for miles over 1500 miles) + a terminal charge of \$27.05."<sup>221</sup>

The SIFL is a per-mile formula rate, to be revised periodi-

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219. *Id.* Question & Answer No. 22.

220. The special rule may only be used on the following types of flights on employer-provided airplanes:

- (a) Flights that originate and terminate in the United States; or
- (b) Flights that originate in the United States and terminate in Canada (or vice versa); or
- (c) Flights that originate in the United States and terminate in Mexico (or vice versa).

*Id.* Question & Answer No. 27.

221. *Id.* Question & Answer No. 23.

cally, calculated by the Department of Transportation beginning January 1, 1985.<sup>222</sup> The appropriate SIFL multiples are as follows:

1. 125% of the SIFL rates for any employee who is not a key employee.

2. 125% of the SIFL rates for a flight by a key employee if there is a primary business purpose for the trip made by the airplane. Entertaining an employee or other individual is not a business purpose.

3. 600% of the SIFL rates for a flight by a key employee if there is no primary business purpose for the trip.<sup>223</sup> A "key employee" is any employee who is a five percent owner, or an officer of the employer, or who, with respect to the particular flight by the airplane, controls the use of the airplane.<sup>224</sup>

When there is *no* business purpose for the trip by the airplane, the special rule may not be used to value a trip taken by a key employee. Compensating an employee is not considered a business purpose.<sup>225</sup> The special rule may also not be used to value a flight on an airplane on which the employer offers air transportation to customers in the ordinary course of business.<sup>226</sup> That is, the special rule may not be used to value commercial flights, but only flights on private company airplanes.

The value of flights derived under the special rule is applied on a passenger by passenger basis. For example, if an individual accompanies an employee on a personal trip, then the flight taken by the individual is taxable to the employee. The employee would include in his gross income both the special rule value of his flight and the flight taken by the individual accompanying him. Any individual accompanying a key employee is treated the same as a key employee for purposes of flight valuation.<sup>227</sup>

Such a result seems incongruous in light of the reasoning behind the no-additional-cost exclusion available for free or discounted flights on commercial airlines provided on a stand-by

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222. *Id.*

223. *Id.* Question & Answer No. 25.

224. *Id.* Question & Answer No. 26.

225. *Id.* Question & Answer No. 25.

226. *Id.* Question & Answer No. 23.

227. *Id.* Question & Answer No. 25.



basis to employees, their spouses and dependent children.<sup>228</sup> Since the employer airline is deemed to incur no substantial additional cost by giving away seats to employees that would otherwise remain unused, the value of the flight is not taxable to the employee. Although the no-additional-cost exclusion is not available for flights on private company airplanes, there seems to be no reason why it should not be if the same restrictions are applied. For example, if an employee is flying on an employer's airplane for business purposes and the flight is scheduled to go with unused seats, the employer, like the commercial airline, would incur no substantial additional cost by making seats available to other employees and their spouses and dependent children.

Use of the special rule is optional and neither the employer nor the employee is bound by the other's use of the rule. If the special rule is adopted by an employer or an employee for any calendar year, then it must be used by the person adopting the rule for all flights taken in the calendar year which qualifies for special rule valuation.<sup>229</sup>

If the special rule is not used, the value of a flight on an employer-provided airplane is the fair market value as determined by all the facts and circumstances.<sup>230</sup> For example, if a key employee flies on a trip with no business purpose, the flight is valued at the cost of chartering a similar airplane for a similar trip. The charter cost must be apportioned equally among all passengers on the flight, excluding non-key employees.<sup>231</sup>

The special valuation rule for flights on employer-owned airplanes imposes a staggering administrative burden on users. A far simpler and less burdensome method would be to value these flights at the same rate as a commercial coach flight with the same destination. Flights for key employees could be valued at a rate equivalent to a first class flight.

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228. See *supra* notes 57-85 and accompanying text.

229. Temp. Regs., *supra* note 181, Question & Answer No. 28, at 752-53.

230. *Id.* Question & Answer No. 29, at 753.

231. *Id.*

#### 4. *Valuation of Free or Discounted Commercial Airline Flights*

Section 61 includes in the gross income of the recipient, the value of free or discounted commercial airline flights that are not eligible under the no-additional-cost service exclusion provided by section 132(a)(1) for flights by airline employees and their spouses and dependent children.<sup>232</sup> For example, the value of free or discounted flights used by other relatives or friends of the employee would be includable in the gross income of the employee as the person performing the services in connection with which the free or discounted flight is provided.<sup>233</sup>

In order to qualify under the special rule, the free or discounted flight must meet the following requirements:

1. The flight is provided on an airplane on which the employer offers transportation to customers in the ordinary course of business;
2. The employer, by carrying the additional passenger, incurs no substantial additional cost determined without regard to any amount paid for the flight — the individual must fly on a “stand-by basis”;
3. The flight is subject to the types of restrictions customarily associated with flying on an employee stand-by basis.<sup>234</sup>

If all of the above requirements are met, the flight is valued at fifty percent of the actual carrier’s highest unrestricted coach fare in effect for the particular flight being valued.<sup>235</sup>

Use of the special rule is optional and an employer or an employee is not bound by the other’s use of the rule. If the special rule is adopted by an employee or employer for any calendar year, it must be used for all flights in the calendar year which qualifies for use of the special rule.<sup>236</sup>

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232. See *supra* notes 57-85 and accompanying text.

233. Temp. Regs., *supra* note 181, Question & Answer No. 30, at 753.

234. *Id.* Question & Answer No. 32.

235. *Id.*

236. *Id.* Question & Answer No. 34.

### III. Temporary Regulation Section 1.162-25<sup>237</sup> — Deductions with Respect to Non-Cash Fringe Benefits

When a fringe benefit is provided to an employee, the amount an employer may deduct as compensation paid to the employee is determined under section 162 and its regulations.<sup>238</sup> The temporary regulations provide that if an employer includes the value of a non-cash fringe benefit in an employee's income, the employer may not deduct both this amount, as compensation for services, and the costs incurred by the employer in providing the benefit to the employee. For example, an employer makes an automobile available to an employee solely for his personal use. The employer uses the special valuation rule and the annual lease value is \$2100. This is the same amount the employer actually paid to lease the automobile for the calendar year. The employer would only be entitled to deduct \$2100 with respect to the automobile. He could not deduct both the cost of leasing the automobile and the annual lease value.<sup>239</sup>

### IV. Temporary Regulation Section 1.132-1<sup>240</sup> — Excludable Fringe Benefits

The temporary regulations issued under section 132 address issues relating to the definition and application of the working condition fringe exclusion and the nondiscrimination rules, including providing a definition of a "highly compensated employee," one of the major questions left unanswered by the statute. Unfortunately, the remaining and most complex parts of the statute were left untouched. Although the regulations purport to provide guidance in the application of the line of business restriction for purposes of the no-additional-cost service and qualified employee discount exclusions, they do no more than reiterate what is already stated in the statute.

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237. Temp. Reg. § 1.162-25 presents a question and answer relating to compensation deductions for non-cash fringe benefits covered by section 162 of the Code. *Id.* at 755.

238. Temp. Regs., *supra* note 181, Question & Answer No. 8, at 750.

239. *Id.* Question & Answer No. 6, at 754.

240. Temp. Reg. § 1.132-1, contains questions and answers relating to the exclusion of certain fringe benefits under section 132 of the Tax Reform Act of 1984. *Id.* at 753-55.

### A. *Working Condition Fringe*

An excludable working condition fringe is any property or service provided to an employee to the extent that, if the employee had paid for the property or service himself, his payment would be an allowable deduction to the employee under sections 162 or 167.<sup>241</sup> For example, a working condition fringe exclusion occurs when the employer provides the employee with a subscription to a trade journal or pays the employee's membership fees in a professional association. The temporary regulations greatly restrict the availability of the working condition fringe exclusion. Under the new rule, a payment will not be deemed an allowable deduction for purposes of the working condition fringe exclusion, if it is unrelated to the *employer's* trade or business.<sup>242</sup> This is true even if a payment would be an allowable deduction under sections 162 or 167. Thus, although not explicitly stated in the regulations, the new test for excludability appears to be that the payment must be an allowable deduction to both the employer and employee under sections 162 or 167.

If an employer provides an employee with an automobile solely for a business use, the value of the automobile is excludable from the employee's gross income as a working condition fringe. The exclusion also applies to employee flights on an employer's airplane that are primarily for business purposes.<sup>243</sup> When the automobile is used for both business and personal purposes, the amount of the respective uses must be apportioned, and the value of the automobile's personal use is taxable to the employee under section 61. For example, the availability of an employer-provided automobile for a full year is \$2000. If the employee drives the automobile 6000 miles on his employer's business and 2000 miles for personal use, the value of the working condition fringe is \$2000 multiplied by a fraction, the numerator of which is the business-use mileage (6000 miles) and the denominator of which is the total use mileage (8000 miles). The value of the excludable working condition fringe is \$1500 and the amount includable in the gross income of the employee

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241. See *supra* notes 120-39 and accompanying text.

242. Temp. Regs., *supra* note 181, Question & Answer No. 3, at 753.

243. *Id.* Question & Answer No. 9, at 754. See *infra* notes 284-86 and accompanying text.

is \$500.<sup>244</sup> If an employee uses different employer-provided automobiles during the year, the rule is applied on an automobile-by-automobile basis.<sup>245</sup>

### B. *Discrimination*

The exclusions available under section 132 generally require that fringe benefits be provided to employees in a manner that does not discriminate in favor of officers, owners, or highly compensated employees.<sup>246</sup> The temporary regulations define a "highly compensated employee," for purposes of section 132, as any employee who has compensation greater than the compensation of ninety percent of all employees of the employer.<sup>247</sup> There are two exceptions to this rule:

1. an employee who has compensation of \$50,000 or more a year is a highly compensated employee, regardless of whether he meets the ninety percent test; and

2. an employee who has compensation of \$20,000 or less a year is not a highly compensated employee, unless none of the other employees have compensation in excess of \$35,000.<sup>248</sup>

The term "employee" does not include an individual who does not perform services for the employer as an employee during the calendar year. For example, although active employees, retired employees, and widows and widowers of employees are all deemed to be "employees" for purposes of section 132(f)(1)(B), the ninety percent test and the second exception to the ninety percent test apply only to the active employees.<sup>249</sup>

If an employer establishes several fringe benefit plans or arrangements, the plans may be aggregated for purposes of applying the discrimination tests, depending on the facts and circumstances in the particular case.<sup>250</sup> For example, a store provides a twenty percent discount to all employees under one fringe benefit plan. Under a separate plan, the store provides an additional fifteen percent discount to a group of employees defined under a

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244. *Id.* Question & Answer No. 4, at 753-54.

245. *Id.* Question & Answer No. 6, at 754.

246. *See supra* notes 56, 81-85, 118-19 and accompanying text.

247. Temp. Regs., *supra* note 181, Question & Answer No. 14, at 755.

248. *Id.*

249. *Id.* Question & Answer No. 15.

250. *Id.* Question & Answer No. 12, at 754.

classification that discriminates in favor of highly compensated employees. Since one plan is discriminatory on its face, the plans are aggregated to determine if they are discriminatory when considered together. Since when considered together the plans would still be discriminatory, the qualified employee discount exclusion available under section 132(a)(2) would not apply to the prohibited group members who are participants in both plans. No exclusion would be available with respect to either plan. Therefore, the entire thirty-five percent discount provided to the prohibited group members is includable in gross income.<sup>251</sup> Rebates or cash bonuses that are adjusted according to the amount of purchases made by the employee are treated as being equivalent to discounts for purposes of applying the discrimination rules of section 132.<sup>252</sup>

#### V. Temporary Regulation Section 54.4977-1<sup>253</sup> — Elective “Grandfather” Rule

Section 4977 provides an elective grandfather rule that allows an employer, under certain circumstances, to treat employees of all the employer's lines of business that existed on January 1, 1984, as employees of one of those lines of business for purposes of providing excludable no-additional-cost services or qualified employee discounts provided in section 132(a)(2) and 132(2).<sup>254</sup> The elective grandfather clause applies only if on and after January 1, 1984, at least eighty-five percent of all employees are treated as employees of the one line of business that entitles them to the excludable service or discount.<sup>255</sup>

An employer makes the section 4977 election by filing a statement before the end of the calendar year preceding the year in which the election will apply.<sup>256</sup> For calendar year 1985, the employer has until March 31, 1985 to file. Extensions are availa-

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251. *Id.* at 754-55.

252. *Id.* Question & Answer No. 13, at 755.

253. Temp. Reg. § 54.4977 contains questions and answers relating to the lines of business election under section 531(e)(1) of the Tax Reform Act of 1984. *See id.* at 757-58.

254. *See supra* notes 75-81, 117 and accompanying text.

255. Temp. Regs., *supra* note 181, Question & Answer No. 2, at 758.

256. The statement is filed with the director of the service center with which the employer's tax returns are filed. *Id.* Question & Answer No. 3.

ble.<sup>257</sup> The election applies to all calendar years following the calendar year in which the election is made, unless the employer revokes the election.<sup>258</sup> If an employer does not make a timely election with respect to 1985 or revokes an election, then he cannot use the grandfather rule election in subsequent years.<sup>259</sup>

## VI. Summary

Although administratively burdensome and generally more complex than necessary, the temporary regulations provide answers to some of the more pressing questions raised by the new legislation. The regulations are, however, extremely uneven. They address some areas in excruciating detail, but completely ignore other areas. The drafters seem to have focused entirely on employer-provided automobiles and airplane flights. They have failed to consider any other type of non-cash fringe benefits. Hopefully, answers to these remaining questions will be provided by the final regulations. In this regard, the Service is seeking comments on all aspects of the new rules but has asked, in particular, for remarks on the following issues before adopting final regulations:<sup>260</sup>

1. Ease of administration and appropriateness of the special valuation rules. In particular, comments are requested on the manner in which employers and employees should elect to use these special rules, including any necessary reporting requirements.

2. The need for special valuation rules for benefits other than those covered by the regulation, such as employer-operated eating and athletic facilities, international flights on employer airplanes, and use of employer-provided automobiles in foreign countries.

3. Establishing a safe harbor for business use of automobiles by sales and service personnel that would eliminate some of the record-keeping requirements.

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257. *Id.* Question & Answer No. 4 (The Commissioner has discretion to grant extensions.).

258. *Id.* Question & Answer No. 5.

259. *Id.* Questions & Answers Nos. 6, 7.

260. Proposed Rulemaking, *supra* note 181, at 837. See *infra* text accompanying note 289.

4. Comments relating to the definition of "employee" for purposes of the section 4977 grandfather rule. Specifically, comments as to whether, and to what extent, retirees should be included in the definition of employee.

5. The circumstances under which retirees should be officers, owners, or highly compensated employers for purposes of the nondiscrimination rules of section 132.

6. Comments on a separate announcement made by the Service on December 27, 1984, which would exclude special-purpose farm vehicles, like tractors and combines, from the new requirements restricting private use of business vehicles.

The nature of these questions put forth for comment suggests that the temporary regulations will undergo substantial change before presented in final form.

The treatment of nontaxable fringe benefits has recently re-emerged as a major tax policy issue as a result of the ever increasing federal deficits. The House Ways and Means Subcommittees on Social Security and on Select Revenue Measures conducted hearings on fringe benefits on September 17 and 18, 1984. At the hearings administration officials testified that nontaxable fringe benefits constitute a large drain on federal revenues and erode the income and social security tax bases, reducing federal income tax revenues by almost \$53 billion and social security tax revenue by almost \$11 billion in 1983. These losses are projected to grow to \$64 billion and \$14 billion, respectively, by 1985.<sup>261</sup> Moreover, on November 27, 1984, the Treasury issued a report on tax simplification and reform.<sup>262</sup> Partly in response to the concerns voiced at the House hearings, this report recommends the repeal of the exclusion of most fringe benefits from income.

Under the Treasury's proposal, there would be a ceiling on the amount of tax-exempt health insurance.<sup>263</sup> Life insurance

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261. *This Week's Tax News*, 24 TAX NOTES 1213 (1984).

262. TREASURY DEPARTMENT REPORT TO THE PRESIDENT ON TAX SIMPLIFICATION AND REFORM, Nov. 27, 1984, reprinted in 71 STAND. FED. TAX REP. (CCH) No. 52, at 1 (Nov. 29, 1984).

263. TREASURY DEPARTMENT REPORT TO THE PRESIDENT ON TAX SIMPLIFICATION AND REFORM, GENERAL EXPLANATION OF TREASURY DEPARTMENT PROPOSALS, Dec. 3, 1984, reprinted in 71 STAND. FED. TAX REP. (CCH) No. 53, at 1, 28-33 (Dec. 6, 1984).



would lose all favorable tax treatment.<sup>264</sup> The exclusion for employer-provided dependent care would be repealed.<sup>265</sup> Educational assistance, group legal services, employee awards, and even van pooling<sup>266</sup> would become fully taxable, as would income of voluntary employees' beneficiary associations,<sup>267</sup> supplemental unemployment benefit trusts,<sup>268</sup> and black lung trusts. Individual retirement accounts would be expanded.<sup>269</sup> Unemployment compensation and workers' compensation benefits would be taxed.<sup>270</sup> The distributions of employer-sponsored retirement plans would be changed,<sup>271</sup> and 401(k) salary reduction plans would be eliminated.<sup>272</sup> Cafeteria plans would also lose favorable tax treatment.<sup>273</sup>

The Treasury offered the following explanation for its proposal:

The tax-free character of fringe benefits causes employees to overconsume these benefits relative to their actual desire or, in many cases, need for them. . . . The spiraling cost of health care in recent years may be attributable in significant part to overconsumption of health care by employers for whom such care is not only tax free but, in many cases, available without limit . . . .

The exclusion of fringe benefits from income is also inconsistent with the tax system's principles of horizontal and vertical equity. Taxpayers not working for employers with qualified benefit plans must purchase goods or services such as term life insurance or legal services with after-tax dollars. In contrast, taxpayers receiving the same goods as fringe benefits in effect purchase them with pre-tax dollars . . . .

The unequal distribution of fringe benefits has caused some to conclude that they should be made even more broadly available. This approach would only exacerbate the distortions and revenue costs of existing law, and it would remain seriously unfair to lower income taxpayers. Under the progressive rate structure, an

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264. *Id.* at 34-35.

265. *Id.* at 39-40.

266. *Id.* at 41.

267. *Id.* at 48-49.

268. *Id.*

269. *Id.*

270. *Id.* at 56-61.

271. *See id.* at 318-23.

272. *Id.* at 335-36.

273. *Id.* at 44-45.

exclusion from income yields a greater tax benefit to a high-bracket taxpayer who received the same amounts of non-taxable fringe benefits, the exclusion of such benefits from income would still provide a disproportionate benefit to higher income taxpayers.

A final and most serious consequence of the current exclusion of fringe benefits from income is the resulting erosion of the tax base. As the base of taxable income narrows, the rates of tax on nonexcluded income must increase in order to maintain the same level of revenue. The percentage of total compensation paid as fringe benefits has grown significantly in recent years, as employees and employers have understandably responded to the tax system's incentives. This shrinkage of the tax base must be reversed before meaningful reductions in tax rates can be achieved.<sup>274</sup>

Because of these concerns, there is a strong possibility that major legislation will be passed in 1985 or 1986. This legislation could make radical changes in the entire nontaxable fringe benefit area, including the possible elimination of section 132, before the Service ever gets to issue final regulations. Even if no new legislation is forthcoming, the era of the moratorium of fringe benefit regulations may re-appear. On January 3, 1985, a bill was introduced in the House to permanently prohibit the issuance of regulations on the taxation of fringe benefits.<sup>275</sup>

#### *Amended Temporary Regulations — February 20, 1985*

The temporary regulations relating to the treatment of fringe benefits issued on January 7, 1985<sup>276</sup> were amended in part by new temporary regulations issued by the Service on February 20, 1985.<sup>277</sup>

The amended temporary regulations provide that vehicles

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274. *Id.* at 27.

275. H.R. 187, 99 Cong., 1st Sess. (1985).

276. *See supra* notes 181-260 and accompanying text.

277. Taxation of Fringe Benefits, T.D. 8009, 50 Fed. Reg. 7,038 (1985) (proposed Feb. 20, 1985) [hereinafter cited as Amended Temp. Regs.]. The Proposed Rulemaking previously issued, *see supra* note 181, was withdrawn and superseded by a new Notice of Proposed Rulemaking. Taxation of Fringe Benefits; Withdrawal of Previous Notice of Proposed Rulemaking and Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations, 50 Fed. Reg. 7,073 (Feb. 20, 1985) [hereinafter cited as Notice of Proposed Rulemaking]. The text of the amended temporary regulations also serves as the text of the new proposed regulations. *Id.*

other than automobiles ("road vehicles") are also fringe benefits that are includable in an employee's gross income under section 61 if provided by an employer for an employee's personal use.<sup>278</sup>

The amendments also provide that the special rule for valuation of an employer-provided automobile — the "Annual Lease Value"<sup>279</sup> — is not applicable to valuing the availability of vehicles other than automobiles provided by the employer.<sup>280</sup> However, the special rule for valuing commuting use of an employer-provided automobile<sup>281</sup> is applicable to vehicles other than automobiles.<sup>282</sup> The value of commuting uses has been changed from four dollars per day to three dollars per day. The amendments specify that this three dollar amount includes the value of any goods or services provided by the employer in connection with the commuting use of the road vehicle.<sup>283</sup>

To use the special rule for valuing the availability of an employer-provided vehicle for commuting, the temporary regulations provide that the employer must require the employee to commute in the vehicle for bona fide noncompensatory business reasons.<sup>284</sup> The notice of proposed rulemaking provides the following examples of acceptable business reasons:

1. the availability of an employee to respond at any time to a radio dispatch or similar call (for example, a utility company truck equipped with tools necessary to respond to a power emergency);
2. the elimination of a significant expense for the employer because of the need to provide security for, or to garage, the vehicle (for example, the danger of vandalism in the case of a vehicle parked overnight on a construction site), and
3. the attendant public benefit derived from such require-

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278. Temporary Regulation § 1.61-2, *see supra* text accompanying notes 217-18, was amended by removing the word "automobile" and substituting the words "road vehicle." Amended Temp. Regs., *supra* note 277, Questions & Answers Nos. 20, 21, at 7041. The term "road vehicle" means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways. *Id.* Question & Answer No. 11. *See supra* notes 200-01 and accompanying text.

279. *See supra* notes 200-07 and accompanying text.

280. Amended Temp. Regs., *supra* note 277, at 7040.

281. *See supra* notes 217-19 and accompanying text.

282. Amended Temp. Regs., *supra* note 277, at 7040.

283. *Id.* Question and Answer No. 21, at 7041.

284. *See supra* text accompanying notes 217-19.

ment (for example, a police automobile parked in public view).<sup>285</sup>

In addition, the amendments reflect changes made by the Tax Reform Act of 1984, which require that any deduction or credit for "listed property" be substantiated with "adequate contemporaneous records."<sup>286</sup> "Listed property" includes property used for transportation. Accordingly, an additional question and answer has been added to explain how the "adequate contemporaneous record" will determine the amount, if any, of an employee's working condition fringe under section 132<sup>287</sup> with respect to an employer-provided vehicle.<sup>288</sup>

The Service is seeking comments<sup>289</sup> from the public on all aspects of the temporary regulations and the amended temporary regulations before issuing its final regulations.<sup>290</sup>

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285. Notice of Proposed Rulemaking, *supra* note 277, at 7074.

286. Section 274(d) of the Code was amended by section 179 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.), to provide that no credit or deduction shall be allowed with respect to any "listed property" (as defined in I.R.C. § 2808(d)(4)), unless the taxpayer substantiates any deduction or credit with "adequate contemporaneous records." Temporary Regulations under section 274(d) were issued on October 24, 1984 (49 Fed. Reg. 42,701). Those regulations were also changed by the Amended Temp. Regs., *supra* note 277, to clarify the types of records that are generally necessary to substantiate any deduction or credit.

287. See *supra* text accompanying notes 243-45.

288. Amended Temp. Regs., *supra* note 277, at 7042-46.

289. See *supra* text accompanying note 260.

290. Notice of Proposed Rulemaking, *supra* note 277, at 7074. The Service has also announced that it will hold a public hearing on the proposed regulations relating to the taxation of fringe benefits on April 16, 17, and 18, 1985. Notice of Public Hearing on Proposed Regulations, 50 Fed. Reg. 7,072 (Feb. 20, 1985).