NOTES

FEDERAL INCOME TAXATION OF EMPLOYEE FRINGE BENEFITS

The Department of the Treasury has recently issued a discussion draft of the first comprehensive regulations dealing with the taxation of benefits received by employees from goods, services, facilities, or reimbursements provided by employers. Although the language of section 61(a) of the Internal Revenue Code, which defines gross income as including "all income from whatever source derived," and the interpretation of this language by the Supreme Court, are broad enough to allow taxation of most of the employment benefits dealt with in the draft regulations, these


Concern about the issue of exclusion of incidental employment benefits from gross income may have been stimulated by the publicity attending former President Nixon's use, for purposes which often appeared personal, of goods and services provided by the Government. A congressional investigation concluded that the former President received gross income from certain of these uses. See Joint Comm. on Internal Revenue Taxation, Examination of President Nixon's Tax Returns for 1969 Through 1972, S. Rep. No. 768, 93d Cong., 2d Sess. 163, 200-01 (1974) [hereinafter cited as President Nixon's Taxes].


3 See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-30 (1955) ("Congress applied no limitations as to the source of taxable receipts, no restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted."). See also Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177, 181 (1945) (statute "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation"). Although the Treasury apparently interprets Smith as restricting taxable employment benefits to those which are intended as compensation, see Treas. Exam., supra note 1, at 77,619, Smith's language is not necessarily exclusive, and the later Glenshaw Glass case has clearly established a broader interpretation, see President Nixon's Taxes, supra note 2, at 158; N.Y. Bar Rep., supra note 1, at 5-12.

5 The draft regulations would generally allow the exclusion from gross income
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regulations would continue, for the most part, the present administrative practice of generally excluding incidental employment benefits from gross income. This Note analyzes the difficulties inherent in taxation of employer-provided benefits and reimbursements, focusing on the analogous issues raised by the deduction of employment expenses. The Treasury Department’s attempted resolution of these difficulties is evaluated, and alternative rules are suggested which provide both fairer and simpler treatment.

I. A Framework for Analysis

A. Objectives of Taxation

Fundamental notions of proper public policy suggest that the objectives of equity and efficiency should be pursued to the extent administratively feasible in the development and implementation of any tax system. These objectives reflect the basic beliefs that government endeavors should encourage the efficient allocation of resources and should afford like treatment to individuals except to the extent warranted by their different situations.

Equity has two distinct components: horizontal equity and vertical equity. Horizontal equity may be defined as equivalent tax treatment of individuals who receive the same amount of income. This objective requires that employment benefits received in kind not be taxed differently from cash benefits; it may be difficult, however, to ascertain what constitutes equivalent treatment of cash and in-kind benefits. This requirement is especially significant because the availability of fringe benefits is likely to vary greatly among jobs. Horizontal equity also requires that the taxability of an item used for trade or business purposes not depend on whether it is furnished by the employer, whether the employer reimburses the individual for his expense in obtaining the item, or whether the individual personally bears the item’s cost. Thus, considerations of horizontal equity suggest that an employ-
ment benefit should be excluded from gross income only if the employee could have deducted its cost had he paid for it himself.

Vertical equity refers to the tax treatment of persons with different amounts of income. Under a progressive income tax system vertical equity requires that those with higher incomes pay a higher proportion of their incomes in taxes. Exclusion from taxable income of all fringe benefits would be regressive if such benefits constitute a greater proportion of total compensation in higher income occupations. Indeed, this may be the case, both because of the nature of executive and professional life and because the highly-compensated have a greater opportunity to structure the form of their remuneration.

Allocative inefficiency—inefficiency in production and consumption—will result if only some forms of economic benefits are taxed, because the after-tax prices of the benefits will not reflect their true relative value to society. That is, the relative costs of goods will be altered while the real resources in the production of various goods and the benefits obtained from them will not change. Taxed goods will be underconsumed; untaxed goods will be overconsumed. Consumers of taxed goods will be subsidizing consumers of untaxed goods. For instance, if employer reimbursements for restaurant meals were excluded from income, but the amount spent by employees who eat dinner at home were not deductible from gross income, the price to an employee of restaurant meals relative to that of home meals would be decreased, resulting in excess consumption of restaurant meals and underconsumption of home meals. More generally, if all in-kind benefits provided by employers were excluded from gross income, two types of distortion would occur. First, more in-kind compensation and less cash compensation would be provided. Second, labor would shift to those occupations which are especially amenable to the provision of fringe benefits.

See H. SIMONS, supra note 7, at 8-12 (equity requires that tax rates be progressive).

Unions also have substantial bargaining power to structure the form of employee compensation. To the extent that the poorest workers are nonunionized, however, this only accentuates problems of vertical equity.

Thus, the practical inability to tax leisure and psychic income gives an added incentive to enjoy leisure and to engage in employment with psychic benefits. See H. SIMON, PERSONAL INCOME TAXATION 52-53 (1938). The egalitarian theorist would advocate giving fewer employment benefits to those with more absorbing work. See THE ECONOMIST, Dec. 13, 1975, survey at 13 (Governor Brown of California suggesting that janitors be paid more than judges, since the latter have the more interesting work).

Considerations of administrative feasibility require that the objectives of equity and efficiency be pursued through the formulation of criteria which give the employer and employee clear guidelines as to the taxability of various benefits and which do not present difficult problems of valuation. These administrative considerations impose significant constraints on the attainment of the objectives set forth above.

B. A Model for Optional Taxation of Fringe Benefits and Employment Expenses

Complete equity and efficiency would require taxation of all economic benefits which a taxpayer obtains from his employment.13 When these benefits are rendered in kind, the ideal basis for their taxation would be the reduction in cash compensation which the employee would be willing to accept in return for provision of the benefit. Only if the basis for taxation is this "employee cash valuation" of in-kind compensation will the employee's relative valuation of cash and in-kind benefits be unchanged before and after imposition of an income tax, and will the amount of tax which he pays not be dependent on the form in which he is compensated.14 Employee cash valuation of in-kind compensation will never exceed the market cost of an item, because the employee would never be willing to "pay" his employer, by the acceptance of reduced cash compensation, more than he would have to pay for the item if he bought it himself. Since employee cash valuation as defined herein will never be greater than market value, taxation on this basis will not entail taxation of consumer's surplus.15

Under this neutral regime of taxation, there would be no tax incentive to render compensation in kind. However, some compensation would still be given in kind rather than in cash because of economies which may result.16 First, if an employer is able to provide a good at a cost to him below its employee cash valuation, a

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13 Economic benefit — anything for which an individual would exchange cash — is the essence of the definition of income used by many taxation theorists. See, e.g., Haig, The Concept of Income — Economic and Legal Aspects, in THE FEDERAL INCOME TAX 5-7 (R. Haig ed. 1921); H. SIMONS, PERSONAL INCOME TAXATION 61-62, 205 (1938); H. McCauley, Fringe Benefits and Their Federal Tax Treatment 19-20 (1959). However, such a definition has not consistently informed the federal income tax system. See Treas. Exam., supra note 1, at 77,618–19.


15 Consumer's surplus is the difference between what an individual would be willing to pay for a good and its market cost. Our cash-based tax system leaves such surplus untaxed.

16 Analogously, some compensation would still be given in the form of reimbursements. See pp. 11758–59 infra.
savings will be produced equal to the difference between these two amounts.\textsuperscript{17} The relative bargaining strengths of the employee and the employer will determine what portion of the savings each captures. If the employee has any bargaining power, then the amount by which cash compensation is reduced when in-kind compensation is provided will be less than the employee's cash valuation of the in-kind compensation. This amount will be called the "contribution to compensation"\textsuperscript{18} of providing in-kind benefits to employees.\textsuperscript{10}

In-kind benefits may also be provided if an employee derives personal enjoyment from something which serves other business purposes of the employer; a single expenditure may be both a payment for the employee's services and a payment for another input in the production process. For instance, a retail clothier may provide clothes free of charge to his employees in order to allow customers to see the clothes being modeled, as well as to provide employee compensation. Although the advertising value of this arrangement may not justify the cost of the clothes to the employer, the employer will nevertheless provide the clothes as long as employee cash valuation of them is greater than the difference between their cost and their advertising value. The resulting savings—equal to employee cash valuation minus the difference between employer cost and advertising value—will be shared by the employer and the employee in accordance with their relative bargaining strengths.

Whether a fringe benefit is provided solely as compensation or also serves other business functions, the employee should ideally be taxed on his full valuation of the benefit. This avoids giving any tax incentive to render compensation in kind, and is required for

\textsuperscript{17} This may be demonstrated by a numerical example. Suppose that the cost to the employer of providing a good, which has a market value of $10 per unit, is only $5 per unit, and that the employee would be willing to pay the employer $10 for the first unit of the good, $10 for a second unit, $8 for a third unit, $6 for a fourth unit, and $4 for a fifth unit. Employee cash valuation equals $34 for four units of the good. Employer cost in providing four units equals $20. Thus, the savings is $14. Four units is the optimal amount of in-kind provision of the good since the savings resulting from any more or any fewer units is less than $14.

\textsuperscript{18} If only payments intended as compensation are taxable, see note 4 supra, then contribution to compensation, rather than employee cash valuation, should be taxed, because this is the amount of additional cash compensation which would otherwise be given. However, the difference between contribution to compensation and employee cash valuation is the amount of the in-kind savings captured by the employee; this would appear to be encompassed by the definition of income in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), see note 4 supra.

\textsuperscript{10} Employee cash valuation sets the upper limit on the amount by which cash compensation may be reduced; cost to the employer sets the lower limit. Whenever the employer and employee share the savings, contribution to compensation is greater than employer cost and less than employee cash valuation.
maximization of horizontal and vertical equity. No distortion in production results because the employer is able to deduct the full cost of the item whether its contribution is solely compensatory, solely related to another business purpose, or a combination of both.\footnote{INT. REV. CODE of 1954, § 162 provides that all "ordinary and necessary" business expenses, including a reasonable amount of compensation, are deductible.}

The problems of determining whether fringe benefits should enter into taxable income and how they should be valued are conceptually equivalent to the problems of determining whether and to what extent employment-related expenses should be deducted from gross income. Just as a fringe benefit may be provided for both compensatory and noncompensatory reasons, an employee or self-employed individual may make a purchase both because it is useful to his trade or business and because it has consumption value to him. When the sum of the business and personal values of an item purchased by an employee exceeds the cost of the item, a savings is created which is analogous to the savings resulting from the provision of fringe benefits.

The treatment of deductions which would be optimal from the perspectives of equity and efficiency parallels the theoretically appropriate taxation of fringe benefits. This treatment would require that the employee who buys an item which is both business and personal in nature should deduct the full cost of the item but include in income the personal value of the item.\footnote{The personal value of the item is analogous to employee cash valuation of an in-kind benefit, taxation of which does not entail taxation of consumer's surplus. In the deduction analogue, however, taxation of consumer's surplus might occur. This may be demonstrated by a numerical example. Suppose an individual could pay $2 for a pure consumption good worth $3 to him and $4 for a pure business-related item which has a business value (produces business income) of $5. Taxable income would be $7: $6 for the consumption good (the $1 of consumer's surplus not being taxed) and $1 for the business item ($5 business income minus a $4 business deduction). If the individual instead pays the initial $6 for a dual purpose good which results in $3 in consumption value and $5 in business value, he would pay tax on $2 of income under the approach discussed in text: $3 in personal valuation plus $5 in business income minus a $6 deduction.} The net effect of this scheme would be to allow the taxpayer to deduct only the difference between the cost of the item and its consumption value to him.\footnote{This is also the result reached by Halperin, supra note 14, at 863.} For instance, if an expenditure of ten dollars by an employee results in eight dollars of personal benefit, the employee should be allowed to deduct only two dollars, regardless of the business value of the expenditure. This result is the same as allowing full deduction of the cost of the item (ten dollars) and inclusion in gross income of the personal benefit obtained (eight dollars).
However theoretically appealing it might be to tax employee cash valuation of all employment benefits, whether obtained in the form of in-kind benefits or from deductible business expenditures, there exist serious conceptual and administrative obstacles to implementation of this principle. The major conceptual difficulty is a "baseline" problem: employment benefits must be conceived as the incremental well-being which employment provides above some base level of welfare, but there is no uniquely preferable base to select. For example, an employee working outdoors in Minneapolis might be expected to be paid more in cash compensation than an employee in Santa Barbara doing the same job, because the employee in Minneapolis must endure severe cold. If the Santa Barbara employee is not taxed on the personal benefit which he derives from working in Santa Barbara warmth rather than Minneapolis cold—that is, on the increase in cash compensation which he would demand if he had to work in extreme cold—it could be argued that horizontal inequity results because the Minneapolis employee is paying more tax although he receives the same net benefit as the Santa Barbara employee. Still, it would be incorrect to conclude that the theoretically correct baseline temperature is simply the lowest temperature endured by an employee, for it is conceivable that some individual might prefer this to a higher temperature. Inevitably the conceptually ideal baseline for measuring benefits obtained from employment is dependent upon the peculiar nature of each person's preference structure.

A specific instance of the baseline problem arises with respect to psychic income—the cash valuation of satisfaction obtained from the performance of one's job. If psychic income is not

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23 When he was counsel to the CIO, Arthur Goldberg described this problem as the dichotomy between (taxable) "compensation" and (nontaxable) "conditions of employment," arguing that the line between the two categories depends on "what our current conception of the relative responsibilities of employer and employee happens to be." Goldberg, Compensation Other Than Cash (paper presented before ABA, New York, Sept. 18, 1951), quoted in S. Surrey, W. Warren, P. McDaniels, & H. Ault, I Federal Income Taxation 139 (1972). See also J. Sneed, The Configurations of Gross Income 79, 101-04 (1965) (arguing that "[a]s the community grows richer, and the employer, rather than the employee, increasingly comes to be regarded as the source of consumption items in kind, the scope of [nontaxable] 'working conditions' increases"). While it may be that the appropriate baseline changes over time, Goldberg and Sneed are not convincing in arguing that all perceived employer responsibilities should escape taxation; pensions, paid vacations, and payments of the minimum wage are all subject to taxation.

24 H. McCauley, supra note 15, at 69-71, has suggested that, ideally, only compensation which represents a net addition to total utility should be taxed. Thus, to the extent that compensation is paid to overcome disutilities associated with the job, it would not be taxed. However, this does not avoid the baseline problem, for disutility exists only in comparison with a baseline level of utility.

25 Psychic income may be considered to be negative if the individual derives
taxed, problems of horizontal and vertical inequity result: not all persons who receive the same amount of non-psychic economic benefits obtain the same amount of psychic income, and the amount of psychic income may increase more than proportionately to the amount of non-psychic economic benefits received from employment. Moreover, the tax incentive to engage in jobs with high psychic income causes an allocatively inefficient pattern of job distribution. Yet, taxation of psychic income would entail severe conceptual, as well as administrative, difficulties because the theoretically justifiable baseline for measurement of this form of income is the lowest possible dissatisfaction each individual could suffer in performing his job.

Closely related to the baseline problem are three administrative difficulties of attempting to measure and tax cash valuation of all employment benefits. First, it would be very difficult to draw up an exhaustive list of employment benefits. Second, employee dishonesty in identifying and valuing these economic benefits would be virtually undetectable. Finally and most importantly, valuation of the benefits would be nearly impossible; even a taxpayer schooled in utility theory would have little idea of how much cash he would require in return for surrender of an employment benefit. These difficulties raise questions concerning both the feasibility of taxing all employment benefits on the basis of employee cash valuation, and the social and political desirability of the intrusions on privacy which would be necessitated by such a scheme.

Nevertheless, the administrative and conceptual constraints which prevent the attainment of allocative neutrality and taxpayer equity do not compel us to ignore these objectives; rather, they may be pursued within such constraints. These constraints do impose two requirements on a personal income tax system: first, criteria must be developed for determining which employment-related benefits will enter into taxable income; second, a basis other than employee valuation for taxation of fringe benefits must be used.

disutility from performing his job. Cf. H. Simon, PERSONAL INCOME TAXATION 53 (1938) (discussing the problem of taxing compensation in kind received by a Flügeladjutant who accompanies a prince to the theater and opera but who detests these activities).

26 The administrative difficulties described may not be absolute constraints; perhaps through the use of lie detectors and other testing methods, the true employee cash valuation of all employment benefits could be ascertained. However, even apart from privacy considerations, the cost would doubtless be considered prohibitive, because no one would consider it worth the increased equity which would result.
II. DETERMINING TAXABLE INCOME: CURRENT TREATMENT OF DEDUCTIONS AND EXCLUSIONS FROM GROSS INCOME

Since fringe benefits and employment expenses are analytically identical, the principles governing the taxation of each ideally should be consistent with the other in order to further efficiency and equity and to avoid abuse. Examination of the statutory, judicial and administrative treatment of both employment expenses and fringe benefits, however, demonstrates that the former have more often been subject to taxation than have the latter. Perhaps as a result, the principles and rules relating to deductions are more developed than those relating to exclusions. Even so, the general approach to deductions results in undertaxation when compared with the optimal scheme of taxation set forth in Part I.

A. Deduction of Employment Expenses

The Internal Revenue Code has been interpreted as allowing deduction of noncapital expenditures which are "appropriate and helpful" to the taxpayer's trade or business, but it does not allow deduction of personal expenses. The case law, statutes and regulations relating to dual benefit expenditures have taken four approaches to reconciling the deductibility of business expenditures and the nondeductibility of personal expenses. The basic approach, which may be called the "business rationality" test, allows full deduction of an expenditure as long as it is appropriate and helpful to the business—that is, to the extent the business benefit alone would justify making the expenditure—even if it also confers personal benefits. When this test cannot easily be applied, other approaches are taken. One of these, the "primary purpose" test, allows full deduction only if the business motivations of the taxpayer are more important than his personal ones. Another scheme, the "apportionment" approach, divides the expenditure in proportion to the relative importance of its business-related and personal components, allowing deduction only of the former. Finally, some benefits characterized as "essentially personal" may not be deducted at all, however great their business motivation in particular cases.

The "business rationality" test was applied in Sanitary Farms Dairy, Inc., in which a Pennsylvanian dairy farmer was allowed to deduct as advertising expenses the full cost of an African

The court acknowledged that the taxpayer received substantial personal enjoyment from the trip, but allowed the deduction because it found that the promotional benefit obtained from the safari could not have been purchased at a lower price by conventional advertising. Thus, the business rationality test ignores the personal benefit which an expenditure may also produce, perhaps because the courts wish to avoid the valuation difficulties inherent in attempting to assess personal benefits obtained from dual purpose expenditures. More likely, the disregard for personal benefit received stems from the erroneous assumption that taxation of such benefits would discourage efficient business spending. However, the failure to tax personal benefits from business-related expenditure in fact results in distortion in production because the relative cost of business activities which also confer personal benefits is artificially reduced.

When the entire expenditure would not be justified by the business benefit thereby obtained, a consistent application of the business rationality test would allow deduction of the expenditure only to the extent that it is appropriate and helpful to the production of income. Implementation of this principle requires allocation of a dual purpose expenditure between the portion which confers business benefits and the portion which confers personal benefits, allowing deduction only of the former. This extension of the business rationality approach is followed by the regulations pertaining to expenses such as meals and lodging incurred when the taxpayer travels away from home: deduction is limited to the cost of those meals and nights of lodging which are related to business activities. Because it is assumed that such expenses do not simultaneously give rise to both business and personal benefits, there is no need in determining what may be deducted to estimate the expense.

30 Today these expenses would be governed by Int. Rev. Code of 1954, § 274, which has stricter rules relating both to the deductibility of foreign travel, see pp. 1151–52 infra, and the deductibility of entertainment expenses, see note 41 infra. See S. Rep. No. 1881, 87th Cong., 2d Sess. 28 (1962).
33 See p. 1153 infra for the appropriate tax treatment, under the business rationality test, of expenditures on activities or items which cannot be allocated because they simultaneously give rise to both business and personal benefits.
ployee's valuation of personal benefits received. Rather, he simply is disallowed deduction for the market cost he has incurred in obtaining those benefits which are purely personal.55

However, when the same activity simultaneously gives rise to personal and business benefits, allocation and valuation of dual-purpose expenditures is particularly difficult because it is often impossible to determine the extent to which such expenditures have a business rationale. Thus, the tax system frequently makes rough approximations designed to ensure that most truly "appropriate and helpful" business expenditures can be deducted. For example, when a taxpayer undertakes both business and personal activities while traveling, it is not immediately clear whether his transportation costs should be considered a business or a personal expense. Unlike hotel bills, which may be allocated on the basis of the nature of each day's activity, the cost of an airplane flight has no obvious allocative benchmark. Therefore, the regulations relating to domestic travel use a "primary purpose" test, allowing full deduction of the cost of transportation when a trip is primarily for business reasons and disallowing any deduction when a trip is primarily for personal reasons.56 Under this approach, the cost of travel may escape taxation in some cases where it would not have been undertaken had there not been personal benefit involved, and may be fully taxed in some cases where the personal benefit would not have been great enough to justify taking the trip.

In implementing the primary purpose approach, the regulations call for examination of all the "facts and circumstances," but mention as an important indicator only how the taxpayer spends his time at his destination.1

It was to reduce this type of abuse that Congress in 1962 created a test relating to transportation to foreign destinations differing from the domestic primary purpose criterion. The de-

55 However, it may be difficult to assess the appropriate market cost of personal items which are obtained at a discount price because they are purchased with business items.
57 See id. § 1.162-2(b)(2).
ductibility of most foreign transportation is now governed by an apportionment approach, under which full deduction would not be allowed even if the trip's primary purpose was the conduct of business. Indeed, the apportionment approach, unlike allocation under the business rationality approach, only allows deduction of that fraction of an item's cost which is equal to the ratio of the business value to the total (business and personal) value. In general, only that proportion of the cost of foreign travel which is equal to the proportion of days at the destination spent primarily on business activities may be deducted. Of course, apportionment of time between business and personal matters will not necessarily correspond to the relative business and personal benefits obtained from the trip. Even if only one-third of the days are spent on personal matters, for instance, the personal benefits obtained may justify taking the trip. However, examination of the relative time spent on each type of activity, which is characteristic of both the primary purpose and the apportionment approaches, may be the only practical way in many situations to estimate the extent to which business motivations would have been sufficient for a dual benefit expenditure.

When compared with a strict business rationality approach, the apportionment approach may result in overtaxation, and the primary purpose test may result in either undertaxation or overtaxation. The primary purpose test would allow full deduction of a dual purpose expenditure when business motivation is greater than personal motivation, while the apportionment approach would allow deduction only of that portion of the cost equal to the relative business value of the expenditure. When the sum

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39 When foreign travel is less than one week or personal activities constitute less than 25% of total time on such travel, the "primary purpose" rules of § 1.162-2 apply. See Int. Rev. Code of 1954, § 274(c)(2).

40 See id. § 274(c). The regulations provide that foreign travel is to be allocated on a per day basis; that days will be considered to have been spent primarily on business if "during hours normally considered to be appropriate for business activity, [the] principal activity on such day was the pursuit of trade or business"; and that weekend days will in most cases automatically be considered to have been spent on business. See Treas. Reg. § 1.274-4(d)(2) (1964).

41 At the same time that Congress limited deduction of foreign travel expenses, it also enacted a provision restricting the deductibility of expenditures on entertainment facilities by combining the harshest aspects of the primary purpose and apportionment approaches. Section 274(a) provides that expenditures for entertainment facilities, such as country club dues payments, are entirely nondeductible unless the taxpayer's use of the facility is primarily business-related. See Int. Rev. Code of 1954, § 274(a)(1)(B). Furthermore, no expense for an entertainment activity may be deducted unless "the item was directly related to, or in the case of an item directly preceding or following a substantial and bona fide business discussion . . . that such item was associated with, the active conduct of the taxpayer's trade or business." Id. § 274(a)(1)(A).
of business and personal benefits is greater than cost to the taxpayer, neither of these results is the same as the result which would be reached under the business rationality test; deduction of the expenditure to the extent that it is appropriate and helpful to the taxpayer's business would be less than total cost but greater than the cost proportionate to business activities. For example, if cost equals twelve dollars, business benefit equals ten dollars, and personal benefit equals five dollars, ten dollars could be deducted under the business rationality test. But the full twelve dollars would be deducted under the primary purpose test, and two-thirds of twelve dollars, eight dollars, would be deducted under the apportionment approach.

Conversely, the primary purpose test would allow no deduction of an expenditure which is primarily personal, while the apportionment approach would allow deduction of that portion of the cost which is equal to the relative business value of the expenditure. Both of these amounts are less than the deduction which would be allowed by a strict business rationality test, under which only the difference between cost and business benefit would be taxed. Thus, if the business benefit in the example above were only five dollars and the personal benefit were ten dollars, five dollars would be deducted under the business rationality test. No deduction would be allowed under the primary purpose test, and one-third of twelve dollars, four dollars, would be deducted under the apportionment approach.

None of these results would be reached under the theoretically optimal scheme set forth in Part I. As has been demonstrated, full taxation of the personal benefits an employee obtains in making a dual benefit expenditure would result in deduction only of the difference between cost and personal benefit obtained. If cost equals twelve dollars and personal benefit equals five dollars, seven dollars could be deducted; if personal benefit equals ten dollars, two dollars could be deducted.

With respect to certain types of expenditures, determination of the primary motivating factor or allocation into business and personal benefits would require severe intrusions into privacy and difficult judgments of value and relative significance. Such difficulties may be avoided through the application of per se rules disallowing any deductions for expenditures on specific items which are deemed to be "essentially personal" in nature, despite the fact that they must be made if the individual is to perform his job properly. However, the treatment of such highly personal or virtually universal expenditures is not wholly consistent. As we have seen, statutory provisions allow

42 See p. 1146 supra.
43 However, the treatment of such highly personal or virtually universal expenditures is not wholly consistent. As we have seen, statutory provisions allow
ing and child care expenses cannot be deducted as business expenses, presumably because decisions of where to live and whether to have children are choices taxpayers in similar job situations make in large part because of factors unrelated to employment. Allowing complete deduction might be considered inequitable to childless taxpayers who live near their work, but it would be administratively infeasible to develop and implement criteria for deductibility which are based solely on the business reasons for the expense.

Moreover, such expenditures raise a significant "baseline" problem: where does the taxpayer's business life begin? Nearly all people require clothing and a home away from work and are able to choose whether or not to have children; expenditures related to these items may be necessary to allow the taxpayer to participate in the production of income, but they are also necessary to allow him to participate in other modes of consumption. If such expenditures were deductible, so logically would be the cost of the taxpayer's health care and even leisure activities which refresh his energies. This may explain why it has been held that work clothes which can be worn on the street are nondeductible, even if they are in fact worn solely or principally at work and would not have been purchased by the taxpayer had they not been necessary for his job. Such per se rules have also been adopted with regard to education. Educational expenditures which merely

the cost of meals to be deducted in some instances, even though it might be argued that no expense is more universal and personal. Besides deduction of meals when the taxpayer is away from home on business, see note 34 supra, business meals are deductible without regard to the restrictions of § 274(a). INT. REV. CODE OF 1954, § 274(e)(1). Protection of the restaurant industry may be one reason this allowance exists. Cf. S. Rep. No. 1881, 87th Cong., 2d Sess. 25 (1962) (disallowance of all entertainment deductions could create considerable unemployment in the entertainment industry).

45 See Henry C. Smith, 40 B.T.A. 1038 (1939), aff'd per curiam, 113 F.2d 114 (2d Cir. 1940) (business deduction for child care denied under predecessor of § 162). However, certain home and child care deductions are allowed for persons not using the standard deduction. See INT. REV. CODE OF 1954, § 214.
47 Cf. Bittker, The Individual as Wage Earner, N.Y.U. 11TH INST. ON FED. TAX. 1147, 1159 (1953) ("our tax structure could have treated the cost of maintaining one's health as a business expense").
49 See Donnelly v. Commissioner, 262 F.2d 411 (2d Cir. 1955); Harry J. Sanner, 38 P-H TAX. CT. MEM. ¶ 69,084 (1969).
increase the taxpayer's proficiency in his present occupation may be deducted. But education which qualifies the taxpayer for a new occupation is pursued because of an essentially personal choice of career and lifestyle and thus is nondeductible.  

B. Exclusion of Fringe Benefits

While the law relating to the exclusion of employer-provided benefits is less developed than that relating to the deduction of employment expenses, those exclusion rules that do exist are generally consistent with the "business rationality" approach described above. The only statute relating to the taxation of employment benefits furnished for both compensatory and non-compensatory reasons is section 119, which provides that meals and certain lodging may be excluded from gross income when they are provided on the premises of the employer for his convenience.  

The regulations state that benefits are provided for the convenience of the employer when they are given for a "substantial noncompensatory business reason."  

In addition, lodging is excluded only if the employee is required to accept it as a "condition of his employment," which is interpreted in the regulations as meaning that it is required in order for the employee "properly to perform the duties of his employment." Although the substantial noncompensatory reason criterion literally would seem to allow exclusion whenever the noncompensatory business purpose is merely more than de minimis, the applications of the criterion in both the regulations and the case law indicate that provision of meals on the employer's premises must be appropriate and helpful in the performance of the employee's job in order to qualify. In the case of lodging, the "proper performance" criterion of the regulations is even more clearly an analogue to the appropriate and helpful standard. As with the business rationality

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52 Treas. Reg. § 1.119-1(a)(2), T.D. 6745, 1964-2 Cum. Bull. 43 (under the heading "meals"). Furthering employee morale or attracting employees will not be considered a "noncompensatory reason" for providing meals. Id. § 1.119-1(a)(2)(iii).
approach in the area of deductions, personal benefit to the employee is ignored as long as noncompensatory reasons justify provision of an item.\(^{56}\)

Employee use of company cars is the only other general class of employer-provided benefits which has been the subject of repeated litigation concerning its inclusion in gross income. It is well established that personal use, including use for commuting, of an automobile owned and maintained by the employer produces gross income.\(^{57}\) Generally, allocation analogous to that under the business rationality test has been applied in determining the amount of income the employee receives. After the total time the employee uses the car is allocated between business and personal uses, the fair rental value for the period of personal use is included in employee gross income.\(^{58}\) The courts have rejected the claim that use of a car may be simultaneously of noncompensatory business value to the employer and of personal benefit to the employee.\(^{59}\)

While the issue of automobile use is readily amenable to an allocation approach because little personal enjoyment can be expected to be derived from hours spent driving on business errands, and little business value can be expected from personal use of an automobile, most other cases present expenditures which simultaneously give rise to both business and personal benefits. Generally, even when the personal benefit obtained is clearly significant, full exclusion is allowed if the employer derives the primary benefit from the expenditure. For instance, in *United States v. Gotcher*\(^{60}\) an employer of an automobile dealer was held to have received no income from a twelve-day expense-paid trip to Germany to tour Volkswagen facilities. The court found that because the "primary purpose" of the trip was to induce Gotcher to take out a Volkswagen dealership, and because Gotcher was "required" to make the trip in order to obtain the dealership, the personal benefit to him was "subordinate to the concrete benefits

\(^{56}\) It appears quite possible that items satisfying the criteria of § 119 may nevertheless be compensatory. See Boykin v. Commissioner, 260 F.2d 249 (8th Cir. 1958) (value of lodging excluded under § 119 even though it was regarded as part of employee's compensation).


\(^{60}\) 401 F.2d 118 (5th Cir. 1968).
However, because Gotcher could show no business purpose for his wife's presence on the trip, he was held to have received taxable income in the amount of the expenses attributable to his wife. And in Allen J. McDonnell, the tax court held that a sales supervisor and his wife, who had been randomly chosen by his employer to accompany contest winners on an expense-paid trip to Hawaii, received no income because the employer sent them on the trip for "sound business reason[s]" even though they also enjoyed the trip.

In circumstances where the possibility of abuse or conferral of personal benefits under the guise of noncompensatory business expenses is particularly great, the courts have more often found some basis on which to assign a specific part of the benefit to taxable income. Thus, when the corporation of which he was the dominant shareholder supplied a Beverly Hills mansion to the musician Liberace, the tax court held that only one-half of the use of the home could be attributed to corporate business, and taxed Liberace on one-half of its fair rental value. Similarly, the majority shareholder and executive officer of a corporation was taxed on that portion of the cost of maintaining a yacht owned by the corporation which the court excluded was allocable to his personal use.

In most cases, however, a fair market value standard has been used to measure the amount of income received from fringe benefits, with taxation on the basis of out-of-pocket cost only when this provides the best estimate of market value. Indeed, the market value rule, which has long been in the regulations on gross income, now appears to be statutorily required. Section 83, enacted in 1969 primarily to deal with restricted property transfers, provides that any property transferred as compensation is to be included in gross income at its fair market value, less the price paid by the taxpayer. Thus the valuation issue discussed in

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61 Id. at 123.
62 See id.
64 Id. at 67-128.
65 See International Artists, Ltd., 55 T.C. 94 (1970), acquiesced in, 1971-2 Cum. Bull. 3. The corporation was disallowed a deduction for the expenses attributable to personal use of the house, on the theory that this constituted a dividend.
68 See, e.g., United States v. Gotcher, 401 F.2d 118 (5th Cir. 1968).
71 Section 83 also provides that the employer may deduct the difference between
Part I has been resolved in light of the practical need to tax on the basis of a readily identifiable value, even though this may result in overtaxation.\footnote{72}

C. Deduction of Reimbursement Paid by the Employer

The courts have shown little sensitivity to the possibility of abuse in the reimbursement of employee expenses. Nominally, the taxation of reimbursements is governed by the rules relating to deductions. When an employee is reimbursed for travel or similar activities "incurred by him solely for the benefit of his employer" for which he accounts to his employer, he need not even report these reimbursements on his tax return.\footnote{73} While the regulations provide that if reimbursements exceed "the ordinary and necessary business expenses paid or incurred by the employee," the employee must include the excess in income,\footnote{74} the courts and the Internal Revenue Service have generally been content to allow all reimbursements to be excluded from taxable income.\footnote{76} The evident rationale for this posture is that reimbursement of an expense tends to indicate its deductibility by the employee since it has passed the "critical scrutiny of corporate officers concerned with the elimination of needless expense."\footnote{76} Yet the potential for disguising compensation in the form of reimbursements is identical with the potential for disguising compensation in the form of fringe benefits. For example, an employer will reimburse the cost of expensive lodging, even though the employee's use of a more modest hotel room would equally serve the employer's noncompensation.

fair market value and the price paid by the employee. \textit{Id.} \S 83(d). This deduction may be inappropriate: in a competitive situation with no restrictions on the amount of an item he can sell at a fixed price, the employer suffers no foregone revenue as long as the price he charges his employees equals his cost.\footnote{72} Only when the true cost of an item to the employer is equal to employee cash valuation (the cost arrived at after subtracting any noncompensatory business value of the item purchased) will the employee not be disadvantaged by being taxed on fair market value or on the amount he is reimbursed. In this situation, the employee could obtain equivalent cash compensation if he so desired, for there is no savings resulting from employer provision of the item or reimbursement for its cost. The fact that the employee instead receives an in-kind benefit paid for by the employer implies that he values it at fair market value.

On the other hand, when fair market value is greater than true employer cost, the employee's cash valuation may be less than fair market value, resulting in overtaxation.

\footnote{72} See \textit{Treas. Reg.} \S 1.162-17(b) (1958).
\footnote{74} \textit{Id.}
FRINGE BENEFITS

pensatory purposes, if the resulting contribution to compensation more than offsets the extra cost of the lavish hotel room.

In at least one instance, however, the IRS has been more stringent, applying the same test in taxing reimbursements that it utilizes when the employee incurs an expense and is not reimbursed. Recent revenue rulings provide that reimbursements for educational expenses are not deductible unless they are for job-related courses beneficial to the student's career in the employer's business and do not qualify him for a new trade or business.\(^77\)

In the area of reimbursements, as with all deductions, the difficulty of determining employee valuation of the nondeductible item is avoided because the employee is in effect simply taxed on the cost of the item. The full taxation of nondeductible reimbursements, like the taxation of fringe benefits on the basis of fair market value, may result in overtaxation because when an individual does not actually pay for an item, he may not value it at its market cost.\(^78\)

III. THE DRAFT TREASURY REGULATIONS ON FRINGE BENEFITS

Continuing the IRS's historical practice,\(^79\) the draft regulations exclude from taxable income many incidental employment benefits and reimbursements.\(^80\) The Treasury has explained that the difficulty of valuation and the need for a "single self-executing" system of wage withholding mandates that only fringe benefits "which threaten the integrity of the basic system should be taxed."\(^81\) However, when it is determined that an item should not escape taxation, the draft regulations would tax it at fair market value.\(^82\) This measure of income could just as easily have been applied to many forms of incidental employment benefits which the regulations conclude should be left entirely untaxed.\(^83\) Thus, it is likely


\(^78\) See note 72 supra.

\(^79\) See note 2 supra.

\(^80\) See Treas. Exam., supra note 1, at 77,619-20 (policy considerations in developing draft regulations said to be "equity among taxpayers," "valuation problems," "withholding considerations," as well as codification of present practices within statutory authority which is "broad but not mandatorily all-encompassing").

\(^81\) Id. at 77,620.


\(^83\) For example, the fair market value of commercial airline flights, retail discounts, downtown parking facilities, weekend use of company cars, bar association dues, and schooling, all of which would at times escape taxation under the draft regulations, see id. at § 1.61-16(f)(1)-(3), (10), (15), (17), (18), could easily be determined.
that the major policy motivation for the Treasury's uncharacteristic leniency in this area is found in its argument that a contribution to vertical equity would be made by giving low and middle income taxpayers the opportunity to enjoy untaxed economic benefits,\textsuperscript{84} counterbalancing the untaxed benefits which high-income taxpayers have long been able to obtain through deduction of business-related meals, lodging, travel, and entertainment.\textsuperscript{85}

But the contribution of the draft regulations to vertical equity is highly questionable. Vertical equity will certainly not be increased between high-income claimers of deductions and lower income taxpayers who do not enjoy fringe benefits. Moreover, unless high-income taxpayers receive relatively less compensation in noncash forms, the progressivity of tax rates means that high-income persons will enjoy proportionately greater tax savings from a policy of uniform exclusion of fringe benefits from taxable income. While it is true that the regulations would subject to taxation certain notorious executive perquisites,\textsuperscript{86} they would not tax many noncash fringe benefits which are of advantage chiefly to the highly compensated.\textsuperscript{87} Whether or not the regulations would further vertical equity, they would have a deleterious effect on horizontal equity, exacerbating the unfortunate position of taxpayers in whatever bracket whose occupations provide them with few opportunities to enjoy fringe benefits. Further, although the effects of any suboptimal tax system on allocative efficiency must remain somewhat speculative, it is likely that toleration of such an anomaly would have adverse allocative effects. The implication of the regulations that in-kind employment benefits will not be taxable unless, perhaps, of the sort limited to high income taxpayers,\textsuperscript{88} will create an incentive for an employer to substitute work-related benefits for cash compensation,\textsuperscript{89} providing items as fringe benefits which might not be deductible if paid for by the employee.\textsuperscript{90}

The draft regulations set forth three major rules which will be considered seriatim: (1) a provision which generally excludes

\textsuperscript{84} See Treas. Exam., supra note 1, at 77,619–20.
\textsuperscript{85} See pp. 1230–52 supra.
\textsuperscript{87} The regulations state that taxable income might not result from employer-provided schooling for the children of overseas employees, from monthly cocktail parties and annual outings, or from an executive's friends and family accompanying him on a business trip on a company airplane. See id. § 1.61–16(f)(6), (17), (18).
\textsuperscript{88} See examples in note 86 supra.
\textsuperscript{89} See p. 1144 supra.
\textsuperscript{90} See p. 1146 supra.
from taxation benefits which an employer provides at no cost to himself; (2) a provision which allows exclusion when warranted by all the "facts and circumstances," and which furnishes nine criteria for implementation of this test; and (3) a de minimis exception which is of general applicability.

A. The "No Substantial Cost" Test

The draft regulations would exclude from taxable income benefits to employees from facilities, goods, or services which (1) "are owned or under the control of the employer for purposes proper to the conduct of the trade or business involved and are not primarily intended as compensation to the employee"; (2) are made available to employees at "no substantial additional cost" to the employer; and (3) are supplied to all employees or to a reasonable classification thereof. 91

The Treasury furnished no rationale for this "no cost" rule, but did provide examples of its application. Two of these examples will be discussed in order to illustrate both the difficulty of finding a rationale for the rule, and the unsatisfactory results which its implementation would yield. 92 In the first example, free flights taken by airline attendants on a space-available basis are excluded from taxable income. 93 The other example concludes that employees of retail stores need not account for discounts which they obtain on merchandise sold by their employer, as long as the price paid is not below wholesale cost. 94

These examples make clear that the "no cost" test is not an analogue to the "business rationality" standard for deductions. 95 Neither the airline company nor the retail store provides these benefits as part of its optimal operation apart from the contribution to compensation resulting from the benefits. Indeed, the flights and discounts are quite obviously supplied solely as compensation. 96 Thus, as with dual purpose expenditures, taxing them

92 Other examples applying the "no cost" rule would exclude airline flights taken by travel agents at nominal cost, discounts given to interior decorators by wholesale furniture manufacturers, free flights taken by friends and family of an executive accompanying him on a business trip aboard a company airplane, and weekend use of company automobiles. See id. § 1.61–16(f)(2), (4), (6), (15).
93 See id. § 1.61–16(f)(1).
95 See pp. 1149–52 supra.
96 Moreover, the exclusion of employer discounts from gross income, which has been a long-standing practice of the IRS, see U.S. INT. REV. SERV., YOUR FEDERAL
would in no way discourage outlays which are appropriate and helpful to the business; it would merely treat these forms of compensation as other forms of compensation are treated.97

The “no cost” rule may be an attempt to encourage use of resources which would otherwise be wasted or which can be made available at no additional social cost; an empty airplane seat, for instance, represents a needless cost in social welfare.98 Several considerations, however, suggest that the realization of any welfare gains from the “no cost” rule is not likely. First, the regulations would apparently evaluate costs only in the short term, allowing opportunities for “no cost” situations to be manufactured in order to take advantage of the savings inhering in untaxed fringe benefits.100 Thus, an airline could increase its seating capacity in the expectation that this would allow more compensatory flights to be provided to employees.101 Secondly, the allocative distortions which result from leaving certain benefits untaxed may be as significant as the cost of leaving an airplane seat empty. Finally, it is questionable whether any fringe benefits are truly costless to an employer, ignoring their contribution to compensation.103 For

97 See p. 1144 supra.

98 However, neither the draft regulations nor the examination of them by the Treasury, see Treas. Exam., supra note 1, indicates that concern for allocative efficiency is the rationale behind the “no cost” rule.

99 Apart from whatever savings may arise because employer cost is below market value, see pp. 1144-45 supra, the nontaxation of fringe benefits produces an additional savings equal to employee valuation multiplied by the tax rate.

100 The measure of cost employed in the “no cost” rule is evidently short-run marginal cost; generally, capital costs are ignored. But cf. Draft Treas. Reg. § 1.61-16(f)(10), 40 Fed. Reg. 44,118 (1975) (employee parking spaces in company-owned garage involve “substantial additional cost” even though garage must also be used for business deliveries and guest parking). Opportunity costs are also ignored in some examples. See note 105 infra.

101 Similarly, a company might engage a larger airplane than would otherwise be required if friends and family of its executives did not travel with them on business trips. See note 92 supra.

102 See p. 1143 supra.

103 In addition to the problems discussed in text, two ambiguities in the concept of “cost” must be considered. First, if the provision of benefits uses up real resources, the benefits thereby obtained are not costless to society even if they are provided at no cost to the employer. For example, an employer might be able to provide free long-distance telephone service to employees at no additional cost to himself because he pays only a fixed monthly fee for the long-distance service. Nevertheless, the long-distance calls by employees are costly to society. Second, a benefit should not be considered costless to the employer merely because the cost of providing it is more than made up by its contribution to compensation. If an item costs the employer $30 and allows a $60 reduction in compensation due to high employee cash valuation of the benefit, the item is “costless” (and indeed has
example, the "free" flight of an airline employee will entail costs of meals, baggage handling, administration, and potential liability, which the regulations would ignore. More importantly, the opportunity cost of employee standby privileges is equal to the revenue foregone by not selling the remaining seats to employees and the general public at a reduced rate. Likewise, a retail employer, even with unlimited inventory, forgoes additional revenue equal to the amount above the discounted price that his employees would be willing to pay for his merchandise.

It would be preferable to tax retail discounts and free flights at fair market value. The allocative distortions and horizontal inequity that result from taxing on a basis above employee cash valuation could well be less than those from not taxing such benefits. For instance, it seems likely that employee cash valuation of a free airline flight will often be closer to the relevant market value than to zero. It should be noted that as long as employee valuation of free flights and retail goods exceeds the tax imposed upon them, such in-kind compensation would continue to be given if the cost to the employer of providing them were really zero. Indeed, as long as employer cost were below employee after-tax cash valuation, employees would continue to fill otherwise empty airline seats. Certainly there is no significant administrative difficulty in taxing either retail discounts or airline flights: in the former case, the market value of the benefit would be the retail cost of the merchandise obtained less the price paid; in the latter case, the market value of the benefit would be the price of a standby ticket.

B. The "Facts and Circumstances" Test

An incidental benefit failing to qualify under the "no cost" rule may nevertheless escape taxation under the "facts and circumstances" test. The draft regulations list nine circumstances, any one of which is "a fact tending to indicate that the benefit does not constitute compensation includable in gross income." No negative net cost) only in the sense that all activities undertaken by a profit-maximizing employer are expected to be profitable.

104 The example in the draft regulations states that the standby flights "do not result in loss of revenue to the airline," Draft Treas. Reg. § 1.61–16(f)(1), 40 Fed. Reg. 41,118 (1975), but this is not true if the airline can legally charge its employees or other potential customers for such standby seating.

105 The example in the draft regulations states that no additional cost is incurred because "the employer merely foregoes additional income." Id. § 1.61–16(f)(3). But foregone income is as much a real cost as are out-of-pocket expenses, as the example dealing with free standby flights implicitly recognizes, see note 104 supra.

106 See pp. 1144–45 supra.

107 Draft Treas. Reg. § 1.61–16(b), 40 Fed. Reg. 41,118 (1975). It is stated that "[t]he following factors, among others, shall be considered where present.
principled explanation for these nine factors is provided other than an expressed desire to codify existing practice.\textsuperscript{108} This aim is embodied in the final factor: that “the item generally is not thought of as constituting [taxable] compensation.”\textsuperscript{100} The other eight factors, which are said to be applications of the ninth,\textsuperscript{110} appear to fall into three major categories. Two of the factors relate, although quite imprecisely, to whether the benefit is appropriate and helpful to the employer’s business apart from any compensatory value it may have. Another group encompasses benefits which relieve the employee of unusual personal expenses which arise because of the nature of the employer’s business. Finally, several of the criteria merely describe situations in which taxpayers would not be able to take abusive advantage of fringe benefits exclusions.

1. Appropriate and Helpful Benefits.—Perhaps the most persuasive factor indicating exclusion is that the benefit in question “accommodates an important requirement of the employer or relieves the employer of significant expense or inconvenience.”\textsuperscript{111} It can be expected that most fringe benefits meeting this standard will be appropriate and helpful to the employer’s business, apart from their contribution to compensation. However, as written, the standard would allow easy circumvention of taxation unless “an important requirement” is understood as excluding the necessity of giving fringe benefits in order to attract\textsuperscript{112} or to compensate employees.\textsuperscript{113} In any case, the language of this criterion could lead to applications concerning specific fringe benefits that would be at variance with the rules concerning deduction of analogous expenditures. For instance, driving an automobile to work instead of taking the bus may fulfill an important requirement of the employer in getting the employee to his job more quickly, but the employee nevertheless may not deduct such commuting expenses.\textsuperscript{114}

The presence of one or more of them will not necessarily be controlling . . . . The failure of a benefit to qualify under one or more . . . factors . . . may be a fact tending to indicate that it does constitute compensation includible in gross income.” Id.

\textsuperscript{108} See pp. 1141-42 & note 6 supra.
\textsuperscript{110} Treas. Exam., supra note 1, at 77,619.
\textsuperscript{112} See p. 1155 & note 52 supra. But cf. Treas. Reg. § 31.3401(a)-1(b)(10) (medical services and similar benefits of small value furnished “merely as a means of promoting the health, goodwill, contentment, or efficiency” of employees need not be included in wages for withholding purposes).
\textsuperscript{113} Thus, an expenditure might accommodate an important requirement of the employer, but not be justified if it did not also contribute to employee compensation. Under both the optimal tax scheme set forth in Part I and the business rationality approach used for deductions, see pp. 1149-51 supra, the expenditure would result in some taxable income to the employee.
\textsuperscript{114} See pp. 1153-54 & note 44 supra.
In light of the "important requirement" factor, it is difficult to understand what is added by a second factor, that the personal use occurs during, immediately before, or immediately after working hours at or near the business premises of the employer and has a proximate relation to work performed by the employee.\textsuperscript{110}

Such circumstances may be of some evidentiary value, indicating whether a benefit is appropriate and helpful,\textsuperscript{116} but as here presented in the form of an independent standard, they could encompass benefits which would not qualify under the business rationality test. Thus, this factor would tend to indicate that no income results from a daily swim and sauna in company facilities.

2. \textit{Unusually Costly Benefits}. — The second group of factors allows exclusion of benefits received because some aspect of the taxpayer’s employment gives rise to unusually high costs for items "normally thought primarily personal."\textsuperscript{117} While there is some precedent for this approach in the allowance of deductions for certain moving,\textsuperscript{118} travel,\textsuperscript{119} entertainment,\textsuperscript{120} meals,\textsuperscript{121} and lodging\textsuperscript{122} expenses, the draft regulations are of wider application than are these deduction rules. For instance, one factor in the proposed regulations allows exclusion of reimbursements for "primarily personal" expenses when "a business requirement of the employer prevented the employee from obtaining the item in the ordinary manner."\textsuperscript{123} Another factor would permit exclusion of any benefit which insures "the employee's safety by protecting against significant risk arising from the employment relation."\textsuperscript{124} An example applying these tests concludes that an employee working a night shift who might normally take mass transit would not


\textsuperscript{116} The examples citing this criterion are all cases in which provision of the benefit in question is also said to fulfill an important employer requirement. These examples include exclusion of supper money for late-working employees, chauffeured limousines for executives attending business appointments, parking for employees who must use cars during the day, vehicles and drivers provided to United States ambassadors for official purposes, a full-time car and driver provided to a city fire chief, and payment by firms of bar association dues. See id. § 1.61–16(f)(8)–(12), (17).

\textsuperscript{117} Id. § 1.61–16(b)(6).

\textsuperscript{118} All taxpayers, including those using the standard deduction, Int. Rev. Code of 1954, § 62(8), may deduct certain moving expenses. Id. § 217.

\textsuperscript{119} Id. § 162(a). See also id. § 274(c) (limiting deductibility of foreign travel).

\textsuperscript{120} "Ordinary and necessary" entertainment expenses are deductible under § 162, subject to the limitations in § 274, see note 41 supra.

\textsuperscript{121} See note 43 supra.

\textsuperscript{122} Int. Rev. Code of 1954, § 162(a).


\textsuperscript{124} Id. § 1.61–16(b)(7).
be taxed on reimbursement of his taxi fare because of the danger of returning home late by any other method. A second example would allow exclusion of reimbursement of supper expenses and taxi fare provided to an employee who works late because of the exigencies of his employer's business. The exclusion from gross income of reimbursements for meals is inconsistent with section 119; moreover, the Tax Court has recently held that supper expenses cannot be deducted. Similarly, taxi fare for the night shift or late-working employee would be considered nondeductible commuting expenses by both the IRS and the courts. Recent cases have rejected deduction for greater than usual commuting expense, whether necessitated by working late or by the absence of residential neighborhoods near the taxpayer's place of work due to the dangers associated with that work. Special hotel and apartment expenses of late-working employees have also been held nondeductible.

A third factor would allow exclusion of a benefit similar to a service "commonly provided by state or local governments in the United States, but which is not readily available to the employees because of the location of their employment." Applying this factor in an example, the draft regulations conclude that no gross income is received by overseas employees whose children attend a tuition-free "American-style" school maintained by their employer. The principle underlying this exclusion may have been that because local taxes that are used to provide various services are deductible from gross income, the provision of typical local government services by an employer overseas, or in the United States where the service is not governmentally provided, should not be included in gross income.

While this principle does recognize the equivalent effect of
exclusions and deductions, it also presents several difficulties. First, many services provided by local governments may be funded in part by federal monies; 135 federal income taxes, of course, are not deductible. 136 Second, the principle has not been applied to allow deductions in analogous situations. Even if a local government does not provide for prekindergarten classes, storm sewers, or road surfacing, expenditures on these items by individuals are not deductible. Third, like local taxes, foreign real property and income taxes are deductible in determining federal income tax liability. 137 While these foreign taxes might not be used to provide the type of services desired by American employees, residents of the United States may also take jobs in areas whose public schools they do not consider appropriate for their children. Expenditures for private schooling, whether incurred domestically or abroad, are nondeductible “personal, family, living expenses.” 138

In one sense, the issue posed by these considerations is a “baseline” problem: are there any services provided with untaxed locally-raised revenue which are so necessary and universally utilized that provision of them by an employer should also be left untaxed? As with all baseline problems, horizontal inequity will result whichever way the issue is resolved. If employer-provided education is untaxed, the overseas employee may be better off than a domestic employee who pays for private schooling; if the education is taxed, the overseas employee may be worse off than the domestic employee whose children attend public schools.

3. Benefits not Provided in a Flagrantly Abusive Manner. — The third, and most problematic, category of factors is apparently intended to allow exclusion of fringe benefits when this would not “threaten the integrity of the tax system.” 139 All three of the criteria in this category would permit exclusion of some benefits the taxation of which would pose no special administrative difficulties and which neither are appropriate and helpful to the employer’s business nor relate to special personal costs imposed on the taxpayer by the employment relationship. The first criterion is that the benefit is provided at a cost to the employer which is

135 It is estimated that in fiscal year 1976, federal aid to state and local governments will equal 34.3% of what those governments spend from their own funds. See Advisory Comm. on Intergov’tal Relations, News Release, April 23, 1976.
137 Id. § 164. Foreign income taxes may alternatively be taken as a credit against federal tax liability. Id. §§ 33, 901-03.
139 Treas. Exam., supra note 1, at 77,620.
insignificant compared with the fair market value of the benefit.\textsuperscript{140} When cost is far below market value, it is likely that provision of the benefit is not solely an attempt to enjoy the advantages of untaxed forms of compensation.\textsuperscript{141} Further, the number of items for which an employer has such a natural cost advantage may be fairly limited. While this criterion may therefore be indicative of lack of abuse of the tax system, it may also, like the similar "no cost" rule, have adverse effects on equity and efficiency.\textsuperscript{142}

A second factor would tend to indicate exclusion when "the benefit is provided to employees generally or to reasonable classifications" thereof, but "not including classifications primarily including only the most highly compensated employees."\textsuperscript{143} Given the objective of vertical equity, it may be appropriate to deny exclusion when a benefit is furnished only to a group of highly-paid employees. Still, provision to all or to a "reasonable classification" of employees should not by itself tend to indicate excludability.\textsuperscript{144} In fact, if an employer provides the same benefit to all his employees, vertical equity among them would be better advanced by taxing the item.

The most puzzling of the nine criteria is that excludability will tend to be warranted where "the benefit is not a substantial amount absolutely or in comparison to the employee’s stated compensation."\textsuperscript{145} Clearly, a benefit which is absolutely or relatively large should be carefully scrutinized if it does not readily appear to qualify for exclusion under another factor. But apart from any administrative difficulties in taxing small benefits, which are addressed by the de minimis rule, there is no compelling reason to exclude smaller benefits from taxation. Further, it would be possible to receive a number of small benefits equaling in value a large benefit which would not qualify under this factor. Another objection to this criterion is the vertical inequity resulting from comparison with stated compensation; a taxpayer making $30,000 per

\textsuperscript{140} Draft Treas. Reg. § 1.61–16(b)(1), 40 Fed. Reg. 41,118 (1975). Another part of this criterion states that exclusion will be indicated when the cost to the employer "is not identifiable." \textit{Id.} While inability to identify a basis for taxation may pose significant administrative difficulties, inability to identify employer cost as such appears irrelevant to whether the item should be subject to taxation.

\textsuperscript{141} See p. 1144 \textit{supra}.

\textsuperscript{142} See pp. 1161–62 \textit{supra}.


\textsuperscript{144} The only classification which the examples in the draft regulations conclude is not reasonable is one primarily limited to company executives. Of course, even if a benefit is provided to all employees of a company, exclusion will not be vertically equitable in the tax system as a whole if most of the employees are highly paid.

\textsuperscript{145} Draft Treas. Reg. § 1.61–16(b)(8), 40 Fed. Reg. 41,118 (1975). No example applying this factor is provided.
year might be able to exclude a benefit for which a taxpayer whose wage is $3.00 per hour would be taxed.

C. The De Minimis Exception

The draft regulations would permit exclusion from income of a benefit when the item is "so small as to make accounting for it unreasonable or administratively impractical." The evident efficiency rationale for this principle makes it an appealing one. Unfortunately, the examples given of benefits which would qualify as de minimis demonstrate that the Treasury would allow exclusion of items whose accounting costs scarcely seem "unreasonable." For example, bar association dues paid by the taxpayer's law firm and retail discounts given to employees are both cited as possible candidates for the de minimis exception. Yet it would be simple for an employer to keep track of these readily quantifiable items. Indeed, he will probably do so in any case for tax deduction and internal cost accounting purposes.

IV. Guidelines for Taxation of Incidental Employment Benefits

The Treasury's draft regulations are excessively permissive in their approach to the taxation of incidental employment benefits. Their presumption against taxation will tend to defeat not only horizontal equity and allocative efficiency but also vertical equity, an explicit objective of the draft regulations. Although assessing the administrative cost of a less permissive approach is admittedly difficult, it is clear that in several respects more comprehensive taxation of fringe benefits would not be impracticable. At the very least, tax treatment of fringe benefits could be more conducive to equity and efficiency if, within practical limitations, this treatment were consistent with the rules and principles relating to the analytically analogous area of deductions.

But even the current treatment of deductions is too permissive to the extent it allows appropriate and helpful expenses to be deducted regardless of the personal benefits associated with them. Thus, it is suggested that in both the fringe benefit and employment expense areas, the IRS and the courts should be more persistent in taxing an item when its personal benefit is at least as great as its market cost. One way of addressing this issue is to consider whether the item might have been purchased for per-
sonal reasons by the employee if it were not provided by the employer or did not have business value to the employee.

The following are suggested rules for implementation of a more equitable and efficient approach to the taxation of incidental employment benefits: 140

(a) Generally, a benefit should be excluded from gross income if it is necessary to the proper performance of the employee's job and it is unlikely that its personal value approximates its market value. The principle underlying this rule is exclusion of benefits when they are appropriate and helpful to the employer's business apart from contribution to compensation, unless it appears that their full value should be taxed because they confer significant personal benefits. The first part of the rule is an extension of the test used in current regulations dealing with exclusion of lodging which the employee is required to accept. 150 As in the case of lodging, an “objective” standard should be used to determine whether a particular benefit is necessary to proper job performance. 161 While the rule is similar to the two “appropriate and helpful” factors of the draft regulations, it is less inclusive, for it encompasses neither benefits which are provided to encourage an employee to perform his job 162 nor benefits of relatively great personal value.

(b) When a benefit is both necessary to the employee's performance of his job and compensates him for that performance, it should be allocated between these two functions to the extent feasible. Generally, as in the area of deductions, this allocation will be easiest if the time the benefit is used for personal reasons

140 These rules may allow more items to be excluded by employees using the standard deduction, see Int. Rev. Code of 1954, §§ 141-45, than these employees may take in the form of itemized deductions. Taxpayers using the standard deduction may additionally deduct only those items specifically mentioned in § 62. In effect, § 62 disallows all trade or business deductions by taxpayers whose sole trade or business consists of being an employee, except for expenses allowed under § 162 relating to transportation or travel (including meals and lodging expenses) or which are reimbursements by the employer. The reasoning behind these limitations may be twofold. To some extent, the standard deduction may be considered a substitute for business as well as personal deductions. However, the deductibility of all business reimbursements, not just those related to transportation and travel, suggests that another concern may be that employee expense records are not usually well-documented. Cf. Treas. Reg. § 1.162-17, T.D. 6630, 1963-1 Cum. Bull. 38, 68-69 (1962) (concern evidenced by special and simplified substantiation requirements for employees).

150 See p. 1155 supra.

161 See note 54 supra.

162 For example, Draft Treas. Reg. § 1.61-16(f)(8), 40 Fed. Reg. 41,118 (1975), would allow exclusion of taxi fare provided for an employee who works late because of the press of an employer's business. Taxi fare would not be excluded under the rules proposed in this Note.
does not overlap the time it is used for business reasons.\textsuperscript{153} For instance, an employee's use of a company car on weekends can be regarded as an entirely taxable benefit,\textsuperscript{154} regardless of the complexities of dealing with the car's weekday use by the taxpayer.

(c) If personal value does not approximate market value and allocation is not feasible, the benefit should be excluded from employee income only if the employee uses it primarily in performance of his job. This rule, of course, is similar to the primary purpose test applied in the deduction area. Since by its own terms this rule is not applied except where allocation cannot be made, accurate determination of the primary purpose of a particular item will seldom be possible. However, the rule is not without substantive content, for it does at the very least require a convincing demonstration of a legitimate non-compensatory business reason for providing the item.

(d) Where the cost of accounting for and taxing a benefit is unreasonably large compared with its value, the benefit may be excluded from gross income. This de minimis exception largely parallels that of the draft regulations\textsuperscript{155} but should be applied more sparingly than it is in the examples in the regulations.\textsuperscript{156} Where the employer is likely to have records documenting the recipients and value of a benefit, this de minimis rule will rarely apply. Moreover, even though daily accounting for a small benefit may be impractical, the benefit might not qualify under the de minimis exception if it is given on a regular basis, because a fair estimation of its annual value need not be unreasonably costly to make.\textsuperscript{157} More generally, the rule will be subject to abuse unless the IRS does not hesitate to tax relatively larger amounts on the basis of somewhat rougher estimates of their magnitude.

(e) Where it is well-established that a given item is not deductible when purchased by an employee, the item should be included in gross income when provided by the employer. Certain expenses which are arguably necessary for the proper performance of the employee's job and that may in certain cases have insignificant personal value, such as commuting costs, have unambigu-

\textsuperscript{153} See p. 1151 \textit{supra}.

\textsuperscript{154} The draft regulations would not tax such use, under the "no substantial cost" rule. Draft Treas. Reg. § 1.61-16(f)(15), 40 Fed. Reg. 41,118 (1975).

\textsuperscript{155} Id. § 1.61-16(c).

\textsuperscript{156} See p. 1169 \textit{supra}.

\textsuperscript{157} Other types of benefits which may be difficult to estimate and to account for have been held includible in gross income. See Mendelson v. Commissioner, 305 F.2d 519 (7th Cir.) (estimate by IRS of income from tips, where taxpayer kept no records, held includible in gross income), \textit{cert. denied}, 371 U.S. 877 (1962); Maxwell H. Messenger, 38 P-H Tax Ct. Mem. 1277 (1969) (court accepted IRS's "tip factor" equalling 10% of gross receipts).
ously been held nondeductible. Such rules should, without further analysis, be applied in taxing fringe benefits in order to avoid providing an incentive for in kind provision of these nondeductible items, and to avoid inequity between the employee who wishes to deduct an item and the employee who wishes to exclude a similar item from gross income.

(f) Fringe benefits which are to be included in gross income should be assessed at their fair market value where possible. The only two measures of the value of in-kind compensation which appear administratively workable are employer cost and fair market value. Neither of these will be a consistently fair approximation of employee valuation. Measurement on the basis of employer cost will typically result in undertaxation, while assessment at fair market value will often result in overtaxation. But use of the fair market value standard in the context of the rules suggested above need not be considered unduly harsh, since under these rules the personal value of some job-related benefits will inevitably escape taxation. Moreover, it will generally be easier to estimate fair market value than to estimate per-employee cost incurred by the employer in providing the specific benefit sought to be taxed. However, when fair market value cannot be easily determined except with reference to employer cost, employer cost may become the basis for measurement.

V. CONCLUSION

The premises of the six rules described above are that incidental employment benefits should be treated in the same way as employment-related expenses unless practical considerations prohibit like treatment, and that, to the extent possible, neither ex-

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158 See notes 44, 129 to 130 supra.
159 Only one decision has used taxpayer cash valuation as the basis for measurement of income from in-kind benefits, see Reginald Turner, 13 T.C. Mem. 462, 463 (1954). It has been suggested that fair market value discounted by an arbitrary percentage should be used to estimate income received from certain in-kind benefits. See Guttentag, Leonard & Rodewald, Federal Income Taxation of Fringe Benefits: A Specific Proposal, 6 Nat'l Tax J. 250, 253 (1953).
160 See note 72 supra.
161 The courts have sometimes used cost as an approximation of value. See United Aniline Co. v. Commissioner, 316 F.2d 701 (1st Cir. 1963); John L. Ashby, 50 T.C. 409 (1968).
162 Under the six rules proposed in this Note, benefits which are analogous to personal itemized deductions, such as imputed interest on interest-free loans, "matching" charitable contributions by an employer, and medical services not excluded under §§ 104-05, would be included in gross income. Since there are restrictions on the deductibility of interest, see INT. REV. CODE OF 1954, § 163, charitable contributions, see id. § 170, and medical expenses, see id. § 213, and since taxpayers using the standard deductions may not take such itemized deductions, it is appro-
clusions nor deductions should be vehicles by which personal benefits escape taxation. The premise of the draft regulations, on the other hand, is that fringe benefits should not be excluded from taxation unless to do so would "threaten the integrity" of the tax system. The approach of the draft regulations thus seems to serve primarily the objective of administrative convenience. The integrity of a system of taxation, however, depends to a large extent on the vigor with which it pursues the values of horizontal and vertical equity and allocative efficiency. The rules proposed in this Note should promote these objectives without imposing unacceptable administrative costs.

This is the approach taken in the draft regulations with respect to employer-provided daycare services. See Draft Treas. Reg. § 1.61-16(f)(19), 40 Fed. Reg. 41,118 (1975). But see J. Simpson Dean, 35 T.C. 1083 (1961) (interest-free loan from employer does not give rise to gross income).