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REVISITING THE TAXATION OF FRINGE BENEFITS

Jay A. Soled & Kathleen DeLaney Thomas*

Abstract: The receipt of workplace fringe benefits has become increasingly ubiquitous. As a result of their employment, employees often receive a cornucopia of fringe benefits, including frequent-flier miles, hotel rewards points, rental car preferred status, office supply dollar coupons, cellular telephone use, home internet service, and, in some instances, even free lunches, massages, and dance lessons. Technological advances and workforce globalization are important contributory factors to the popularity of what were, until the turn of this century, previously unknown fringe benefits.

In years past, taxpayers could readily turn to the Internal Revenue Code to ascertain the income tax effects and reporting responsibilities associated with fringe benefit receipt. However, today's fringe benefits have evolved far beyond what Congress contemplated when it enacted fringe benefit reform over thirty years ago. As a result, the existing statutory tax compliance framework does not adequately address the recent transformation of the workplace, as many modern fringe benefits are not specifically excluded from the income tax base yet are not currently being reported as taxable.

This Article examines what has been an increasingly commonplace phenomenon: employers and employees ignoring their responsibilities to report the receipt of fringe benefits as taxable income. It argues that Congress has an obligation to preserve the tax base and, accordingly, must institute reform measures to ensure taxpayer compliance. Failure to take action will trigger an expansion of such fringe benefit offerings, eroding the tax base and jeopardizing the integrity of the income tax system.

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INTRODUCTION

Over a quarter of a century ago, through targeted legislative reforms, Congress sought to end the practice of not reporting on-the-job fringe benefits as taxable income.[1] The congressional fixes are found in several different Internal Revenue Code (Code) sections[2]: Code section 61(a)(1) added the phrase "fringe benefits" to its description of gross income,[3] Code section 132 excluded from gross income certain specifically defined fringe benefits,[4] and employment tax provisions (i.e., Code sections 3121(a), 3306(b), 3401(a), and 3501(b)) expanded the application of payroll taxes to include taxable fringe benefits.[5] The

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. All Code references are to the Internal Revenue Code of 1986, as amended.

3. Deficit Reduction Act § 531(c), 98 Stat. at 884. The IRS defines "fringe benefit" as follows: "A fringe benefit is a form of pay for the performance of services." INTERNAL REVENUE SERV., PUBLICATION 15-B, EMPLOYER'S TAX GUIDE TO FRINGE BENEFITS: FOR USE IN 2016, at 3 (2015), http://www.irs.gov/pub/irs-pdf/p15b.pdf [https://perma.cc/9T48-ATEJ].

4. Deficit Reduction Act § 531(a)(1), 98 Stat. at 877–81.

5. *Id.* § 531(d)(1)(A), (d)(3)–(5), 98 Stat. at 884–85.

legislative history underlying these reform measures indicates that Congress designed these Code sections to clarify the law, limit tax base erosion, and curtail the practice of employers transforming taxable remuneration into tax-free fringe benefits.[6]

But a surprising situation has recently occurred. The country is awash in fringe benefits inuring to employees,[7] a sizable portion of which currently goes unreported as taxable income.[8] These newly minted fringe benefits generally fall within one of three categories: (1) "customer

6. *See* STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 (Comm. Print 1984). The legislative history warned that, absent reform and "without any well-defined limits on the ability of employers to compensate their employees tax-free by providing noncash benefits having economic value to the employee, new practices will emerge that could shrink the income tax base significantly . . . [and] further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash." *Id.* at 841.

7. For example, the provision of free cell phones to employees has become increasingly ubiquitous. *See* SOC'Y FOR HUMAN RES. MGMT., 2014 EMPLOYEE BENEFITS 22, tbl.D-1 (2014), https://www.shrm.org/Research/SurveyFindings/Documents/14-0301%20Beneftis_Report_TEXT_FNL.pdf [https://perma.cc/ST8Z-TAG] (finding that forty-one percent of employers offer free personal use of a business cell phone). A number of other fringe benefits have originated with companies in Silicon Valley. *See, e.g.*, Jillian D'Onfro & Kevin Smith, *Google Employees Reveal Their Favorite Perks Working for the Company*, BUS. INSIDER (July 1, 2014, 10:06 PM), http://www.businessinsider.com/google-employees-favorite-perks-2014-7# [https://perma.cc/9TE2-YPMH] (describing the numerous fringe benefits that Google employees can enjoy); Meghan Keneally, *Noisy Massage Chairs, Over-Inflated Egos and Too Much Free Food, It's a Hard Life at Google: Employees Take to Web to Gripe About Their Job Perks*, DAILY MAIL (Nov. 4, 2013, 1:23 PM), http://www.dailymail.co.uk/news/article-2487276/Former-Google-employees-complain-job-perks.html [https://perma.cc/4AH3-6X8W] (same); J.P. Mangalindan, *Google: The King of Perks*, CNN MONEY (Jan. 30, 2012, 3:18 PM), http://archive.fortune.com/galleries/2012/technology/1201/gallery.best-companies-google-perks.fortune/2.html [https://perma.cc/BC95-L4AM] (same); Melinda Wenner Moyer, *Behind the Scenes at Google's Cafeteria*, BON APPÉTIT (Feb. 19, 2013, 10:00 AM), http://www.bonappetit.com/trends/article/behind-the-scenes-at-google-s-cafeteria [https://perma.cc/G3BF-C2UE] ("As if Google perks like nap pods and on-site masseuses didn't already stoke your envy, the tech giant has reinvented workday dining. Its offices in Mountain View, California, and Manhattan have more than 35 canteens offering fresh, delicious meals and hundreds of pantry-like 'micro-kitchens' stocked with snacks and beverages (including Kind granola bars and Stumptown coffee). And it's all free."). Google is apparently not alone in offering such benefits. Other technology companies such as Facebook, Twitter, Zynga, and Yahoo offer generous fringe benefits as well. Mark Maremont, *Silicon Valley's Mouthwatering Tax Break*, WALL ST. J. (Apr. 7, 2013), http://online.wsj.com/articles/SB10001424127887324050304578408461566171752 [https://perma.cc/Y7JT-Z9KG].

8. *See, e.g.*, Austin L. Lomax, *Five-Star Exclusion: Modern Silicon Valley Companies Are Pushing the Limits of Section 119 by Providing Tax-Free Meals to Employees*, 71 WASH. & LEE L. REV. 2077 (2014) (describing the nonreporting practices of both employers and employees with regard to the many third-party-provided fringe benefits of work); Michael Lundin & Claudia Cowan, *IRS Considers Taxing Work Perks Like Food, Gym Memberships*, FOXNEWS.COM (Apr. 16, 2014), http://www.foxnews.com/politics/2014/04/16/irs-considers-taxing-work-perks-like-food-gym-memberships/ [https://perma.cc/77XR-H597] ("The IRS reportedly is looking at these perks and seeing if these companies need to start paying up for the free stuff they offer employees.").

loyalty programs" such as frequent-flier miles, rental car usage, hotel frequency stays, and office supply purchases; (2) mixed-use (business/personal) assets such as cellular phones and home internet service; and (3) workplace lifestyle enhancements such as the receipt of free lunches, massages, and dance classes. None of these benefits existed in their present form until the turn of the century, and many are provided by unrelated third-party vendors rather than the employers themselves. The evolution of this new era of fringe benefits can be traced to technological advancements and the increasing globalization of the workforce over the past several decades.[9]

Because the aforementioned fringe benefits are not statutorily excluded from gross income under Code section 132, they are presumably includable in gross income under Code section 61.[10] However, these new fringe benefits often go unreported, with no clear statutory or regulatory justification.[11] There are numerous possible reasons why these fringe benefits are rarely reported as taxable income. Their valuation is inherently problematic; their putative "tax-free status" has tremendous political support; recordkeeping for these benefits is administratively challenging; and, over the past quarter of a century, payroll taxes have dramatically risen, making noncompliance more economically attractive.[12] Further, the nonreporting of certain benefits like employer-provided cellphones has received the blessing of the Internal Revenue Service (IRS),[13] while non-enforcement with respect to other types of benefits (e.g., frequent flyer miles) suggests the IRS's tacit approval.

As more employers and employees take advantage of these unreported fringe benefits, Congress must ponder its options. Possible approaches include expanding the list of those fringe benefits excluded from gross income, explicitly stating that some or all of the aforementioned fringe benefits are taxable, and/or denying employer deductions for expenditures pertaining to securing these fringe benefits.[14] In light of growing taxpayer noncompliance, Congress would be wise not to ignore this problem.

This Article urges immediate congressional action. It argues that, if

9. *See infra* Section II.A.

10. *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955) (finding that the congressional intention is "to tax all gains except those specifically exempted").

11. *See* Lomax, *supra* note 8, at 2082–83.

12. *See infra* Section II.C.

13. *See infra* notes 144–45 and accompanying text.

14. *See infra* Part III.

left unaddressed, the failure to tax modern fringe benefits will have continuing pernicious effects on the income tax system. Not only does failing to tax fringe benefits shortchange the government and public of valuable tax revenue on income associated with those benefits, it also perpetuates the notion that tax enforcement is arbitrary and ill-defined.[15] Additionally, not enforcing taxation of certain fringe benefits, while taxing comparable amounts of cash compensation, unfairly favors those employees who have access to fringe benefits.[16] Failing to tax fringe benefits also encourages wasteful spending. More specifically, because employers do not have to factor in taxes when setting compensation amounts, it is cheaper for employers to compensate their employees with untaxed fringe benefits instead of cash, resulting in their overprovision.

This Article makes several contributions to the existing literature. First, it identifies and describes a new era of fringe benefits not contemplated by the current statutory regime. We offer historical context for the evolution of these fringe benefits and identify the unique challenges that policymakers face in designing a workable tax scheme. Next, we offer a number of concrete policy recommendations for taxing fringe benefits in the modern era. While some commentators have argued that modern fringe benefit offerings should be subject to tax in theory,[17] this Article offers practical guiding principles intended to address concerns like valuation, recordkeeping, and the current political climate.

In making its case, this Article proceeds as follows: in Part I, we present an abbreviated history of fringe benefit taxation. Part II then

15. *See, e.g.*, Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax*, 62 DUKE L.J. 829, 832 (2012) (criticizing I.R.S. Announcement 2002-18, 2002-10 I.R.B. 621, in which the agency declared that it will not pursue a tax-enforcement program with respect to promotional programs, pointing out that unless Congress acts, the IRS will be able to create "a de facto, or customary, gross income exclusion, despite the absence of any statutory authority for its position").

16. *See, e.g.*, JOSEPH BANKMAN ET AL., FEDERAL INCOME TAXATION 61 (16th ed. 2012) ("Every tax system that attempts to tax wage income must contend with the nettlesome problem of employer-provided fringe benefits . . . . [F]ailing to tax these benefits creates problems of fairness . . . ."); WILLIAM D. ANDREWS, BASIC FEDERAL INCOME TAXATION 73 (5th ed. 1999) ("Omission of noncash items in the computation of taxable income is unfair because it imposes a smaller burden on some taxpayers than on others in similar overall circumstances."); Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141, 1142–43 (1976) (arguing that failure to tax fringe benefits violates horizontal equity and is also regressive if highly compensated employees have greater access to fringe benefits). *But see* Yehonatan Givati, *Googling a Free Lunch: The Taxation of Fringe Benefits*, 69 TAX L. REV. (forthcoming 2016) (arguing that, in a competitive market, failing to tax fringe benefits does not violate horizontal equity because employers will adjust the wages of employees who receive fringe benefits).

17. *See, e.g.*, Givati, *supra* note 16.

discusses the underlying nature of these newly minted fringe benefits and their evolution alongside recent technological developments and workplace globalization. In Part III, we discuss possible reform measures that Congress should consider and their application.

I. SELECTIVE HISTORY OF THE TAXATION OF FRINGE BENEFITS

From the inception of the income tax in 1913, the receipt of fringe benefits has been an integral part of the nation's economic landscape.[18] Over this time period, the tax treatment of fringe benefits has undergone three distinct stages: (1) the IRS issuance of informal and piecemeal guidance, (2) the promulgation in 1976 of proposed regulations by the Treasury Department, and (3) the passage of congressional legislation in 1984.

A. IRS Guidance

The Sixteenth Amendment to the Constitution authorized a national income tax, and in 1913 Congress quickly followed with the passage of the nation's first constitutionally sanctioned federal income tax.[19] Needless to say, in its infancy, the income tax's initial statutory formulation was fairly rudimentary with few details expounded.[20] In many instances, it was implicitly delegated to the IRS to amplify the law's meaning.

When it came to the taxation of fringe benefits, on several occasions the IRS responded to this embellishment challenge with administrative rulings. The first instance was in 1920, when the IRS ruled that group term life insurance did not constitute taxable income insofar as the employee benefited "only in the feeling of contentment that provision has been made for dependents. It is paid by the employer not as

18. *See, e.g.*, Richard L. Kaplan & Dawson J. Price, *Change and the Continuity in Fringe Benefit Taxation: Seeking Sense and Sensibility*, 59 N.Y. L. SCH. L. REV. 281, 302 (2014/15) ("From the earliest days of the income tax system, Congress and the IRS have struggled to create a sensible framework for the treatment of fringe benefits.").

19. Tariff Act of 1913, Pub. L. No. 63-16, 38 Stat. 114.

20. If the number of words serves as a proxy for detail, consider the fact that in 1913 the income tax law totaled approximately 11,000 words, *see* Tariff Act, 38 Stat. at 166–81; 144 CONG. REC. H2136 (daily ed. Apr. 22, 1998) (statement of Rep. Robert Goodlatte); by way of contrast, the number of words presently in the Code exceeds one million, *see* Joseph Henchman, *How Many Words Is the Tax Code?*, TAX FOUND. (Apr. 15, 2014), http://taxfoundation.org/blog/how-many-words-are-tax-code [https://perma.cc/9VKN-8T5Z] (estimating that in 2013 the Code contained over one million words).

compensation to the employee, but as an investment in increased efficiency."[21] In the same year, the agency issued Office Decision (O.D.) 514,[22] declaring that occasional cash meal allowances were excluded from income.[23] One year later, in O.D. 946,[24] the IRS ruled that the value of train travel offered to railroad employees and their families was excluded from income as a gift, as long as the travel was "not provided for in the contracts of employment."[25] Several decades later, in Revenue Ruling 59-58,[26] the IRS announced that de minimis fringe benefits are not taxable; more specifically, "the value of a turkey, ham, or other item of merchandise of similar nominal value, distributed by an employer to an employee at Christmas, or a comparable holiday, as part of a general distribution . . . as a means of promoting their good will" is exempt from income.[27]

The foregoing IRS administrative rulings are marked by their brevity. Notwithstanding this brevity, these rulings spawned entirely new categories of income that were treated as exempt from taxation (without any authorization from Congress).[28] The group term insurance ruling led employees to exclude from income the value of group term life insurance offered by their employers (the precursor to Code section 79(a)); the "meal money" ruling undoubtedly led many employees to believe that meals (and possibly lodging) furnished for the convenience of their employers were not subject to taxation (the precursor to Code section 119); the "train travel" ruling undoubtedly led many employees to believe that no-additional-cost services provided by their employers were not taxable (the precursor to Code section 132(b)); and the "turkey and ham" ruling undoubtedly led many employees to believe that de minimis fringe benefits that their employers provided were not taxable (the precursor to Code section 132(e)).[29]

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21. O. 1014, 2 C.B. 88, 89 (1920), 1920 WL 48481.

22. O.D. 514, 2 C.B. 90 (1920), 1920 WL 49099.

23. *Id.*

24. O.D. 946, 4 C.B. 110 (1921), 1921 WL 50801.

25. *Id.*

26. Rev. Rul. 59-58, 1959-1 I.R.B. 17, 1959 WL 12389.

27. *Id.* at 18.

28. *See* Zelenak, *supra* note 15, at 843 ("As the government admitted in its brief in a 1962 Supreme Court case, under the IRS's administrative practice fringe benefits were 'not generally . . . considered income to the employees even if the employer's sole reason for providing them [was] to confer a benefit upon the employees—*e.g.*, provision of parking facilities, medical services, swimming pools, libraries, courtesy discounts, etc.'" (alterations in original) (quoting Brief for the United States at 39, Rudolph v. United States, 370 U.S. 269 (1962) (No. 396)).

29. *See supra* notes 21–26 and accompanying text.

But the problem with the IRS approach to fringe benefit taxation was its fragmentation and lack of overall cohesive structure. In the absence of uniformity, some taxpayers pushed the definitional limits of what constituted tax-free fringe benefits.[30] Something more comprehensive had to be implemented.

B. Treasury Department Regulations

In an attempt to bring uniformity to the fringe benefit area of the law, the Treasury Department in 1975 issued a discussion draft of all-inclusive regulations.[31] These regulations had three categories of benefits that qualified for tax-free treatment: (1) those that resulted in no substantial extra costs to employers, (2) those that passed a "facts and circumstances" test, and (3) those that qualified as de minimis in nature.[32]

Qualifying for the "no substantial costs to employers" provision required the satisfaction of three conjunctive conditions: the goods or services originated from the employer and were "primarily unrelated to the personal use or consumption of such items by employees of the employer," the supplying employer incurred no substantial extra costs in the provision of such goods or services, and there was no discrimination of benefit offerings between and among employees.[33] The Treasury Department then cited two examples of such benefits: free flights offered to airline attendants (precursor to Code section 132(b) (i.e., no-additional-cost services)) and merchandise discounts offered to store employees (precursor to Code section 132(c) (i.e., qualified employee discounts)).[34]

Next, under the so-called "facts and circumstances" test, the draft regulations offered nine circumstances that tended "to indicate that the benefit does not constitute compensation includable in gross income."[35]

30. *See, e.g.*, I.R.S. Tech. Adv. Mem. 83-37-012 (May 25, 1983) (stating that a builder's proposed five percent to ten percent employee discount on the retail price of a home did not qualify as a de minimis fringe benefit).

31. Prop. Treas. Reg. § 1.61-16, 40 Fed. Reg. 41,118 (Sept. 5, 1975).

32. *Id.* § 1.61-16(a)–(c), 40 Fed. Reg. at 41,119–20.

33. *Id.* § 1.61-16(a), 40 Fed. Reg. at 41,119.

34. *Id.* § 1.61-16(f)(1), (3), 40 Fed. Reg. at 41,120.

35. *Id.* § 1.61-16(b), 40 Fed. Reg. at 41,119–20. Factors included whether the "benefit is provided primarily to insure the employee's safety by protecting against significant risk arising from the employment relation," whether "the benefit is not a substantial amount absolutely or in comparison to the employee's stated compensation," and whether the benefit "generally is not thought of as constituting compensation includible in gross income." *Id.* § 1.61-16(b), 40 Fed. Reg. at 41,120.

These circumstances attempted to codify existing practices insofar as the receipt of fringe benefits was concerned.[36] However, many commentators, practitioners, and politicians found this "facts and circumstances" test so obtuse that they faulted its proposed application.[37]

Finally, the draft regulations offered an exception to the concept of gross income for de minimis fringe benefits. Benefits that qualified for this exception were defined as those items "so small as to make accounting for [them] unreasonable or administratively impractical."[38] In theory, this rationale made sense; however, the Treasury Department set forth several examples (e.g., bar association dues paid by the taxpayer's law firm)[39] that were neither small in absolute dollar amounts nor hard to track and thus did not conform with the stated rationale for this exception.

As drafted, the proposed Treasury regulations were not well-received.[40] As a result, the Treasury Department withdrew them the following year.[41] Congress then stepped in and issued a moratorium on the further issuance of regulations, rulings, or procedures that would alter the historic tax treatment of fringe benefits.[42] To avoid leaving a legislative void, however, Congress established a special fringe benefit task force that went to work on putting together draft legislation.[43]

C. Congressional Legislation

In 1984, Congress sought to bring uniformity to this area of the law. It therefore passed sweeping legislation, embodied in the Deficit

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36. *See* Note, *supra* note 16, at 1163–64; *see also* Fringe Benefits; Notice of Publication of Discussion Draft of Regulations, 40 Fed. Reg. 41,118, 41,118–19 (proposed Sept. 5, 1975) (to be codified at 19 C.F.R. pt. 12) (discussing the need to provide guidance with respect to administrative practices that allowed exclusion of certain fringe benefits from employees' income).

37. *See* Note, *supra* note 16, at 1163–69 (critiquing the nine factors and finding some to be "problematic" and "puzzling").

38. Fringe Benefits; Notice of Publication of Discussion Draft of Regulations, 40 Fed. Reg. at 41,119.

39. Prop. Treas. Reg. § 1.61-16(f)(17), 40 Fed. Reg. at 41,121.

40. *See* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 63.1.1. (rev. 3d ed. 2005) ("Caught in a heated cross fire between critics who found the proposed regulations too lenient and those who thought they were too severe, the Treasury withdrew its draft in 1976.").

41. Fringe Benefits: Withdrawal of Discussion Draft of Proposed Regulations, 41 Fed. Reg. 56,334 (1976).

42. Act of Oct. 7, 1978, Pub. L. No. 95-427, § 1, 92 Stat. 996, 996.

43. STAFF OF TASK FORCE ON EMP. FRINGE BENEFITS, H. COMM. ON WAYS & MEANS, 96TH CONG., DISCUSSION DRAFT BILL AND REPORT ON EMPLOYEE FRINGE BENEFITS (Comm. Print 1979).

Reduction Act of 1984,[44] that fundamentally transformed the fringe benefit landscape.[45] The stated objectives of this legislation were threefold: first, to "codify the ability of employers to continue many of these practices without imposition of income or payroll taxes";[46] second, to "set forth clear boundaries for the provision of tax-free benefits";[47] and third, to "[curtail] new practices [that might] emerge that could shrink the income tax base significantly . . . . [and] further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash."[48]

How did Congress accomplish its stated objectives? First, it clarified the scope of Code section 61 by explicitly including the phrase "fringe benefits."[49] Next, it added Code section 132, which specifically enumerated those fringe benefits that were to be excluded from gross income.[50] Finally, it expanded the payroll tax provisions to include within their scope the value of fringe benefits that inured to employees' benefit.[51]

At the time, the sweeping congressional solution to the problem of fringe benefit taxation was generally lauded by both the academic community and the general public[52]—and for good reason: Congress had instituted what seemed to be a comprehensive and practical solution to the receipt of tax-free fringe benefits, a problem that had previously plagued the nation and threatened the integrity of the tax base. From a legislative perspective, it was therefore hailed, giving the appearance that this area of the law could theoretically be put on autopilot.

But soon after Congress instituted this comprehensive legislative reform, a series of unanticipated events unfolded that fundamentally transformed the topography of the fringe benefit landscape: customer loyalty programs came into vogue,[53] new technological devices and services emerged (i.e., cellular telephones and the internet),[54] and the

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

45. *Id.*

46. STAFF OF JOINT COMM. ON TAXATION, *supra* note 6, at 840.

47. *Id.*

48. *Id.* at 841.

49. Deficit Reduction Act § 531(c), 98 Stat. at 884.

50. *Id.* § 531(a)(1), 98 Stat. at 877–81.

51. *Id.* § 531(d), 98 Stat. at 884–85.

52. *See generally* Wayne M. Gazur, *Assessing Internal Revenue Code Section 132 After Twenty Years*, 25 VA. TAX REV. 977 (2006).

53. *See infra* Section II.A.1.

54. *See infra* Section II.A.2.

workforce became more globalized.[55] The 1984 congressional legislation left unaddressed how the fringe benefits associated with these transformative events should be taxed.

The next Part of this Article explores the nature of these transformative events and how they led to the emergence of new categories of fringe benefits the likes of which were entirely unknown until the turn of the twenty-first century.

II. THE TWENTY-FIRST CENTURY AND THE REENGINEERED FRINGE BENEFIT

While it is not easy to make broad generalizations about the twenty-first century and the Information Era,[56] there is at least one noticeable trend when it comes to workplace fringe benefits. In the past, fringe benefits predominately originated directly from employers (e.g., seeking to build camaraderie and kinship, an employer would offer significant discounts to its employees on the products it sold).[57] Fringe benefits of this nature no doubt will continue to be a vibrant part of the nation's employment landscape. What is truly new in the twenty-first century, however, is the advent of fringe benefits that typically originate from third-party vendors, such as airlines, hotel chains, rental car companies, office supply vendors,[58] and internet and cell phone providers. These modern benefits represent a departure from the fringe benefits of yesteryear, which typically involved employers providing discounted or free use of their own goods or services, such as railroad employees receiving free train travel. While the legislative history to section 132 clearly contemplates exempting many employer-provided fringes, there is no indication that Congress intended to extend this treatment to third-party provided benefits.[59] These third-party-provided fringe benefits

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55. *See infra* Section II.A.3.

56. For a concise description of the so-called Information Age, see generally NICHOLAS NEGROPONTE, BEING DIGITAL (1995).

57. *See generally Fringe Benefit*, GALE ENCYCLOPEDIA U.S. ECON. HIST., http://www.encyclopedia.com/topic/Fringe_Benefit.aspx [https://perma.cc/G4PJ-2X76] (last visited May 8, 2016) ("Fringe benefits can be generally divided into those offered individually, such as 401(k) retirement plans, and those offered to employees as a group, such as daycare facilities or free lunch.").

58. *See, e.g.*, Tax Analysts, *A History of the Frequent Flyer Program*, 38 TAX NOTES 1311 (1988) (describing how the frequent-flier program got off the ground).

59. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 6, at 840 ("Congress was aware that in many industries, employees may receive, either free or at a discount, goods and services which the employer sells to the general public. . . . Although employees receive an economic benefit from the availability of these free or discounted goods or services, employers often have valid business

financially benefit employees and are not specifically exempt from income;[60] nevertheless, they often go unreported by both employers and employees.[61]

This Part is arranged as follows: Section A explores the genesis of modern fringe benefits that, prior to the turn of the twenty-first century, were largely unknown. Section B offers a brief theoretical overview of how the receipt of these fringe benefits should be taxed.[62] Section C details the reasons that such fringe benefits often go unreported. Finally, Section D provides an overview of the current political landscape and the challenges of reform.

A. The Advent of Modern Fringe Benefits

As the nation has progressed from the Industrial Era (when manufacturing dominated the economic marketplace)[63] to the Post-Industrial Era (when service offerings dominated the economic marketplace)[64] to the Information Era (when computers and technology dominate the economic marketplace),[65] the workplace has been reshaped, work-related technology has filtered into employees' personal lives, and globalization has led to intense competition to lure the best and brightest minds—all of which has led to the emergence of new kinds of fringe benefits. This fringe benefit evolution is developed and explored in the following three subsections: (1) the growth of customer loyalty programs, (2) the ubiquity of cellular telephones and internet service, and (3) the fundamental transformation of the employee workplace.

1. Customer Loyalty Programs

In the modern era of fringe benefits, many employees earn rewards through customer loyalty programs like airline frequent-flier programs.

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reasons, other than simply providing compensation, for encouraging employees to avail themselves of the products which those employees sell to the public.").

60. I.R.C. § 132(a) (2012).

61. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 531(d), 98 Stat. 494, 884–85 (codified as amended in scattered sections of 26 U.S.C.).

62. The tax consequences associated with each of these benefits will be discussed in considerably more detail in Part III.

63. For a concise description of the so-called Industrial Era, see generally T.S. ASHTON, THE INDUSTRIAL REVOLUTION 1760–1830 (1948).

64. For a concise description of the so-called Post-Industrial Era, see generally DANIEL BELL, THE COMING OF POST-INDUSTRIAL SOCIETY (1976).

65. *See* NEGROPONTE, *supra* note 56.

In the employment context, these rewards are generally earned through business-related travel expenses or office supply expenses that are paid for by the employer either directly or through reimbursements. Although the employer incurs the out-of-pocket costs that generate the rewards, the rewards generally inure to the benefit of the employees. For example, an employee might accrue enough frequent-flier miles through work-related travel to purchase a free airline ticket to use on his next vacation. These relatively new fringe benefits are a by-product of a rapidly growing customer loyalty program industry.

The genesis of customer loyalty rewards programs likely dates back to select supermarket chains offering S&H Green Stamps to their repeat customers.[66] The more frequently customers returned and made purchases, the more S&H Green Stamps they would earn, which were redeemable for "free" gifts.[67] Because these so-called free gifts were essentially bargain purchases, neither Congress nor the IRS ever sought to tax their economic value.[68]

As the technology underlying computer software advanced and data storage capacities grew, the opportunity for more sophisticated customer loyalty programs expanded. Customers would no longer have to lick and maintain books of musty stamps. The airline industry was the first to tap into this then-novel technology. In May 1981, with new computer programs and enhanced data storage capacities in hand, American

66. Jennifer Lach, *Redeeming Qualities*, ADVERT. AGE (May 1, 2000), http://adage.com/article/american-demographics/redeeming-qualities/42382/ [https://perma.cc/3MJQ-UYWT]. The name "S&H" derives from the issuer of the stamps, the Sperry & Hutchinson Company. *Id.*

67. Today, S&H has converted its Green Stamps into "Greenpoints," which can be redeemed online for gift cards from retailers like Barnes & Noble, Fandango, and Sports Authority. S&H GREENPOINTS, http://w3.greenpoints.com/ [https://perma.cc/CEJ8-RNH2] (last visited June 8, 2015).

68. Taxpayers who purchase goods or services at arm's length generally do not realize gross income in connection with a bargain purchase, whether it is in the form of a seller rebate or a below fair-market-value price. *See, e.g.*, Pittsburgh Milk Co. v. Comm'r, 26 T.C. 707 (1956); Rev. Rul. 2008-26, 2008-1 C.B. 985; Rev. Rul. 76-96, 1976-1 C.B. 23. In the case of customer rewards programs, the predominant view is that such rewards are equivalent to nontaxable rebates if they are earned through cash purchases by the customer. For example, in the case of cash rewards earned through personal airline travel, the IRS has ruled that:

> a passenger will not realize gross income upon the receipt of a cash payment if the flights that entitled the passenger to receive the payment were undertaken for personal, nondeductible purposes. Instead, the payment will simply reduce the passenger's cost of the tickets purchased under a purchase price adjustment rationale.

I.R.S. Priv. Ltr. Rul. 9340007 (June 29, 1993), http://www.legalbitstream.com/scripts/isyswebext.dll?op=get&uri=/isysquery/irl83c2/1/doc [https://perma.cc/8XHZ-NYBS]; *see also* Sharon Alice Pouzar, *Frequent Flyer Awards as Taxable Income: Time to Pay the Tax Man*, 5 TEX. WESLEYAN L. REV. 55, 64–65 (1998).

Airlines launched the world's first-ever frequent-flier program,[69] and a few months later both Delta and TWA followed with frequent-flier programs of their own.[70]

As the airline industries' frequent-flier programs soared, businesses in the hotel industry began to develop loyalty programs of their own. At first, the hotel industry partnered with the airline industry, offering frequent-flier miles to those guests who repeatedly used their services.[71] Soon thereafter, however, the hotel industry developed its own loyalty programs. In January 1983, for example, Holiday Inn launched the world's first large-scale hotel loyalty program, which was quickly followed by Marriott doing the same.[72]

The rental car industry mimicked the hotel industry's approach. It initially partnered with the airline industry to offer frequent-flier miles, but as technology advanced many rental car companies independently devised their own customer loyalty programs.[73] The first to offer such a stand-alone program was National Rental Car—in March 1987, it introduced its Emerald Club,[74] which was followed by similar programs offered by the majority of other rental car companies.[75]

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69. Lee S. Garsson, *Frequent Flyer Bonus Programs: To Tax or Not to Tax—Is This the Only Question?*, 52 J. AIR L. & COM. 973 (1987); David M. Rowell, *A History of U.S. Airline Deregulation Part 4: 1979–2010: The Effects of Deregulation—Lower Fares, More Travel, Frequent Flier Programs*, TRAVEL INSIDER (Aug. 13, 2010), http://thetravelinsider.info/airlinemismanagement/airlinederegulation2.htm [https://perma.cc/UG73-F37R].

70. *See* Rowell, *supra* note 69.

71. *See* Ed Watkins, *The History and Evolution of Hotel Loyalty*, HOTEL NEWS NOW (Aug. 11, 2013, 6:09 PM), http://www.hotelnewsnow.com/Article/11029/The-history-and-evolution-of-hotel-loyalty#sthash.FUEljQdH.dpuf [https://perma.cc/HJ7Q-LFGA] ("The first generation of hotel loyalty schemes were simply conduits to airline programs: Currency earned in hotel programs could be used toward free flights on participating airlines.").

72. *See id.* ("Two brands lay claim to firsts involving frequency programs in the hotel industry. Holiday Inn launched its program in February 1983, followed by Marriott in November of the same year.").

73. Ryan Lile, *How Rental Car Companies Can Get More Mileage*, COLLOQUY (Apr. 18, 2014), https://www.colloquy.com/latest-news/how-rental-car-companies-can-get-more-mileage/ [https://perma.cc/6KET-QHRW] ("Until recently, rental car companies had not done much to differentiate themselves in terms of loyalty. These companies have interfaced with airline and hotel programs by offering renters frequent flyer miles or hotel points, but have not innovated loyalty products of their own.").

74. Press Release, Enter. Holdings, National Car Rental's Emerald Club Marks 25 Years of Customer Choice, Convenience (Mar. 8, 2012), https://www.enterpriseholdings.com/press-room/national-car-rentals-emerald-club-marks-25-years-of-customer-choice-convenience.html [https://perma.cc/7T3E-J63A] ("National Car Rental, the premier car rental brand for business travel, this month celebrates the 25th anniversary of the Emerald Club, the car rental industry's first frequent renter program. The Emerald Club launched on St. Patrick's Day in 1987.").

75. *See, e.g.*, *Gold Plus Rewards*, HERTZ, https://www.hertz.com/rentacar/emember/rewards-overview/loyalty-free-travel-program [https://perma.cc/JX48-8FVG] (last visited Apr. 17, 2016).

The popularity of customer loyalty programs extends well beyond the service industry. Beginning in April 2007, for example, office supply companies such as Staples began to offer customer loyalty programs.[76] The business platform of such programs is simple: purchase your office supplies with us, and, in return, we will award you with "cash coupons" that you can use in any fashion that you want throughout the store, including to purchase personal-use items such as electronic devices, furniture, and supplies.[77]

Fast-forward to the present. Customer loyalty programs are omnipresent and continue to grow in popularity. Facts and figures regarding these programs are stunning. U.S. consumers held more than three billion customer loyalty program memberships in 2014, over 900 million of which were attributable to the travel and hospitality industries.[78] Total memberships are up twenty-six percent from 2012 and have more than tripled since 2000.[79] A 2010 study estimated the total value of customer rewards and points to be $48 billion, with over $17 billion allocable to airline, hotel, and other travel-related rewards.[80] As

76. *Staples Inc.*, WIKIPEDIA, http://en.wikipedia.org/wiki/Staples_Inc [https://perma.cc/PR4Y-5N29] (last visited Feb. 12, 2015).

77. *Staples Rewards Program*, STAPLES.COM, http://www.staples.com/sbd/content/help-center/staples-rewards-program.html#10005_14 [https://perma.cc/AWS8-GDL2] (last visited June 24, 2015) ("For any purchase you make (excluding postage stamps, phone/gift cards, savings passes), you earn up to 5% back in rewards. Staples Rewards® are issued online monthly at staples.com/rewards in increments of $5. Monthly balances of less than $5 will roll over through the end of the following calendar quarter.").

78. JEFF BERRY, THE 2015 COLLOQUY LOYALTY CENSUS: BIG NUMBERS, BIG HURDLES 5 (2015), https://www.colloquy.com/resources/pdf/reports/2015-loyalty-census.pdf [https://perma.cc/MGF9-WKRX].

79. *Id.* at 2 ("The big finding in the 2015 Census is that the membership growth shows no signs of slowing . . . ."); *see also* Lena Steinhoff & Robert W. Palmatier, *Understanding Loyalty Program Effectiveness: Managing Target and Bystander Effects*, J. ACAD. MARKETING SCI., Aug. 22, 2014, http://foster.uw.edu/wp-content/uploads/2015/04/loyalty-program.pdf [https://perma.cc/Y5LL-ZZHB] ("Loyalty programs, in business practice and as a focus of marketing research, have become vastly popular, such that U.S. companies spend more than $1.2 billion on them each year, program participation has topped 2.6 billion, and the average U.S. household subscribes to 21.9 different programs."); *The Lowdown on Customer Loyalty Programs*, FORBES MAG. (Jan. 2, 2007), http://www.forbes.com/2007/01/02/frequent-flyer-miles-ent-sales-cx_kw_0102whartonloyalty.html [https://perma.cc/D8K8-R5YW] ("According to Jupiter Research, more than 75% of consumers today have at least one loyalty card, and the number of people with two or more is estimated to be one-third of the shopping population. Surveys by information-technology analysts Gartner, Forrester Research and META Group suggest the data-for-dollars explosion is showing no signs of letting up anytime soon.").

80. NANCY GORDON & KELLY HLAVINKA, COLLOQUY TALK, BURIED TREASURE: THE 2011 FORECAST OF U.S. CONSUMER LOYALTY PROGRAM POINTS VALUE (2011), http://www.swiftexchange.com/Content/Documents/2011-COLLOQUY-Liability-Talk-White-Paper.pdf [https://perma.cc/GQN2-T76R].

evidenced by these dollar figures and participant numbers, customer loyalty programs are obviously no longer in their infancy. To the contrary, they have hit full stride, and there is every reason to believe that their popularity will persist and continue to grow.[81]

2. *Mixed-Use Goods and Services*

A second recent development in fringe benefits is the provision of goods or services with a mixed personal/business component, such as smartphones (or other cell phones), cellular service, and/or internet service. This increasingly commonplace practice[82] reflects both developments in technology and growing demands on employees to be available 24/7.

Over the last two decades, the ease of communication has increased at a dizzying pace. For example, telephones that were once anchored to a particular location are no longer tethered and are usable virtually anywhere throughout the world.[83] Similarly, computers that were once stationary and immobile have shed lots of pounds and can easily be carried around on one's person.[84] Finally, the internet, which until fairly recently did not exist, is now universally accessible.[85]

These technological developments led to the development of a more demanding work environment for employees. Consider how in yesteryear one's work environment and personal life were completely separated. When employees left the office or plant, they typically entered an entirely different realm of their existence. They went home, had dinner, perhaps watched television, read the newspaper, and/or attended their child's scholastic or sporting events. From a practical perspective, this disconnect between an employee's work and home made sense because if the office or plant were physically closed, in most instances, only limited communications could be had with office

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81. *See* STEPHAN A. BUTSCHER, CUSTOMER LOYALTY PROGRAMMES AND CLUBS 20–28 (2002) (explaining the popularity of customer loyalty programs and why they flourish); ARTHUR MIDDLETON HUGHES, THE CUSTOMER LOYALTY SOLUTION: WHAT WORKS (AND WHAT DOESN'T) IN CUSTOMER LOYALTY PROGRAMS 2 (2003) ("[I]t is now possible to keep, economically, in a computer the kind of information on customers that the old corner grocer used to keep in his head and to use that to build lasting, profitable relationships with customers.").

82. *See supra* note 7.

83. *See generally* GUY KLEMENS, THE CELLPHONE: THE HISTORY AND TECHNOLOGY OF THE GADGET THAT CHANGED THE WORLD (2010).

84. *See generally* MARTIN CAMPBELL-KELLY ET AL., COMPUTER: A HISTORY OF THE INFORMATION MACHINE (2014).

85. *See generally* JOHNNY RYAN, A HISTORY OF THE INTERNET AND THE DIGITAL FUTURE (2013).

personnel and clients. But the communications industry has had a transformative effect on the manner in which people presently conduct their business and personal lives. When people leave the office or plant for the day, no longer do they necessarily stop working. Instead, on their daily commute, many employees return business telephone calls, text messages, and exchange e-mail. When they are home, they often engage in the exact same activities; and, even when they are on vacation, people stay "connected" with their office.[86] The erstwhile clear demarcation line between people's business and personal lives has never been so blurred.

And while communication costs have declined significantly, staying in touch is still far from free. The annual cost of cell phone ownership is in the neighborhood of $1200,[87] and the annual cost of securing home internet service (which depends in large part on the speed that a user chooses) can run as much as $3600.[88] For an average family, these out-of-pocket expenses can constitute a sizable portion of their disposable income.[89] When an employer alleviates this financial burden by picking up the tab for such costs, it is a significant job perk; when these job perks are not reported as taxable income, it is a serendipitous bonus.

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86. *See, e.g.*, *Americans Stay Connected to Work on Weekends, Vacation and Even When Out Sick*, APA.ORG (Sept. 4, 2013), http://www.apa.org/news/press/releases/2013/09/connected-work.aspx [https://perma.cc/H7GL-L3AW] ("More than half of employed adults said they check work messages at least once a day over the weekend (53 percent), before or after work during the week (52 percent) and even when they are home sick (54 percent). More than 4 in 10 workers (44 percent) reported doing the same while on vacation.").

87. *See, e.g.*, Dave Smith, *Cell Phone Bills Are Up 50% Since the iPhone Was Invented*, BUS. INSIDER (Oct. 24, 2014), http://www.businessinsider.com/chart-of-the-day-cell-phone-bills-are-up-50-since-the-iphone-was-invented-2014-10 [https://perma.cc/KHZ2-7QDN] ("Households spent an average of $913 on phone bills in 2013—and a fifth of those households spent more than $1,400 that year.").

88. *See, e.g.*, Brian Fung, *The Price of the Internet Is Too High*, WASH. POST (Oct. 28, 2014), http://www.washingtonpost.com/blogs/the-switch/wp/2013/10/28/the-price-of-internet-is-too-high/ [http://perma.cc/33RF-KCRN] ("In American cities like New York, you can buy a 500 Mbps connection that's 58 times faster than the U.S. average. Here's the catch: It'll cost you $300 a month . . . ."). On the other hand, a connection speed of only twenty-five Mbps would cost roughly $50 per month. *See* Hannah Yi, *This Is How Internet Speed and Price in the U.S. Compares to the Rest of the World*, PBS NEWSHOUR (Apr. 26, 2015, 12:54 PM), http://www.pbs.org/newshour/updates/internet-u-s-compare-globally-hint-slower-expensive/ [https://perma.cc/P4DR-BT4M].

89. Anton Troianovski, *Cell Phones Are Eating the Family Budget*, WALL ST. J. (Sept. 28, 2012, 3:28 PM), http://www.wsj.com/articles/SB10000872396390444083304578018731890309450 [https://perma.cc/E92C-FGB3] ("Government data show people have spent more on phone bills over the past four years, even as they have dialed back on dining out, clothes and entertainment—cutbacks that have been keenly felt in the restaurant, apparel and film industries.").

3. *Lifestyle Enhancements*

Over the last several decades, the nature of many workplace environments has shifted from work-centric to life-encompassing. With this evolution of the workplace has come a new breed of fringe benefits that serve as lifestyle enhancements, such as free massages and gourmet meals. An examination of the twentieth-century workplace compared to the workplace of today demonstrates why this shift in environment has occurred.

Around the turn of the twentieth century, the United States was in the midst of its Industrial Revolution. At that time and for many decades thereafter, the workplace environment was fairly staid: employees commuted to work, performed their duties, and then commuted home.[90] In many instances, there was almost a complete separation between one's work and home and the activities that transpired at each location. Certainly, prior to the advent of telephones, it was virtually impossible to have on-the-job personal communications with friends, family, and loved ones outside of work. Indeed, even when telephones were introduced into the workplace, the calls incurred charges,[91] constituting a dissuasive factor in employees making personal calls. The same was true when employees left work: most had no home telephones, and thus there was virtually no way for them to stay in touch with the business enterprise. Even after home telephones came into vogue, making work-related calls remained an expensive undertaking.

But technological advancements and globalization have transformed the workplace. The workplace is no longer an isolated island separated in space and time from one's personal life. Now, with a click of a mouse or push of a button on their computers or smartphones, employees can get instant access to their personal e-mail, as well as Facebook and other social media accounts, allowing them to communicate with anyone they wish while at work.[92] This connectedness makes sense as workdays have

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90. *See, e.g.*, DONALD M. FISK, U.S. BUREAU OF LABOR STATISTICS, AMERICAN LABOR IN THE 20TH CENTURY (2001), http://www.bls.gov/opub/mlr/cwc/american-labor-in-the-20th-century.pdf [https://perma.cc/9RB8-DVBF] ("Electricity was in less than 10 percent of the nation's homes at the turn of the century, but it was almost universal by the end of the century."); *see also* CAMPBELL-KELLY ET AL., *supra* note 84, at 3–20 (detailing the few mechanical machines that were available in offices at the turn of the nineteenth century).

91. *See, e.g.*, FED. COMMC'NS COMM'N, STATISTICS OF COMMUNICATIONS COMMON CARRIERS pt. 7 (1996 ed.), http://transition.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/SOCC/95socc.pdf [https://perma.cc/W3XX-SWL2] (detailing the varying telephone toll costs that major communication carriers charged among different cities).

92. While some employers restrict access to personal e-mail, social networking, and other websites on office computers, employees can generally still access these from their own personal

become longer and people's daily commutes have generally increased in duration.[93] Globalization is another factor that has transformed the workplace. With a world marketplace and twenty-four time zones, there is now never a time period when everything is closed. To the contrary, a business can stay fully operational at all times during the day because something is always happening somewhere, whether it be the European or Asian markets. To stay competitive, many employees are putting in longer hours.[94]

Due to this overlap between work and personal lives, employers have tried to make the workplace more enticing and employee friendly. These efforts have perhaps made their greatest mark in Silicon Valley, where there has been a concerted effort to coalesce employees' business and personal lives into a coherent whole. The manifestations of this coalescence are found at work locations that feature a wide array of perks seeking to transcend traditional work/personal boundaries.[95] These at-work offerings include personal concierge services, housecleaning services, laundry machines and dry-cleaning services, haircuts, bowling alleys, yoga classes, and dance lessons, often staffed by outside third-party providers.[96]

The workplace trend set in Silicon Valley is not an isolated phenomenon. Throughout the country, many other businesses have attempted to replicate the Silicon Valley workplace model.[97] This trend

devices like smartphones or tablets.

93. *See, e.g.*, BRIAN MCKENZIE & MELANIE RAPINO, U.S. CENSUS BUREAU, ACS-15, COMMUTING IN THE UNITED STATES: 2009, at 4 (2011), http://www.census.gov/prod/2011pubs/acs-15.pdf [https://perma.cc/5YF6-7XT9] ("Figure 3 shows mean travel time since 1980, the first year the census collected travel-time information. The mean travel time for workers was just under 22 minutes in 1980, then increased between 1980 and 2000 to about 25 minutes, where it remained in 2009.").

94. Lydia Saad, *The "40-Hour" Work Week Is Actually Longer—By Seven Hours*, GALLUP (Aug. 29, 2014), http://www.gallup.com/poll/175286/hour-workweek-actually-longer-seven-hours.aspx [https://perma.cc/SL7Q-CNKS] ("Adults employed full time in the U.S. report working an average of 47 hours per week, almost a full workday longer than what a standard five-day, 9-to-5 schedule entails. In fact, half of all full-time workers indicate they typically work more than 40 hours, and nearly four in 10 say they work at least 50 hours.").

—*By Seven Hours*, GALLUP (Aug. 29, 2014), http://www.gallup.com/poll/175286/hour-workweek-actually-longer-seven-hours.aspx [https://perma.cc/SL7Q-CNKS] ("Adults employed full time in the U.S. report working an average of 47 hours per week, almost a full workday longer than what a standard five-day, 9-to-5 schedule entails. In fact, half of all full-time workers indicate they typically work more than 40 hours, and nearly four in 10 say they work at least 50 hours.").

97. *See, e.g.*, Barry Jaruzelski, *Why Silicon Valley's Success Is So Hard to Replicate*, SCI. AM. (Mar. 14, 2014), http://www.scientificamerican.com/article/why-silicon-valleys-success-is-so-hard-to-replicate/ [https://perma.cc/Y7UP-URM6] ("To be sure, pockets of innovation have emerged on a smaller scale elsewhere in the U.S., like North Carolina's Research Triangle and the Route 128

suggests that businesses will continue to expand existing fringe benefit offerings and add new perks to lure the world's most talented workforce.

B. Overview of the Taxation of Third-Party-Provided Fringe Benefits

In theory, the taxation of fringe benefit receipt should be rudimentary. As an accretion to their wealth, taxpayers who receive fringe benefits from their employers should initially assume that their receipt constitutes taxable income.[98] Next, they should examine whether the fringe benefit in question qualifies under one of eight exclusions to taxability found in Code section 132.[99] If the fringe benefit in question does not qualify within the scope of one of these eight exclusions, its value must be included in gross income, unless another Code exclusion applies (which is rarely the case). If it does qualify by falling within the scope of one of these eight exclusions, its value is excluded from gross income.

Applying this general framework to modern fringe benefits requires a close examination of the Code section 132 exclusions. Section 132 lists eight specific fringe benefits that are excluded from income: (1) no-additional-cost services, (2) qualified employee discounts, (3) working condition fringes, (4) de minimis fringes, (5) qualified transportation fringes, (6) qualified moving expense reimbursements, (7) qualified retirement planning services, and (8) qualified military base realignment and closure fringes.[100]

The vast majority of these exclusions have no plausible application to the modern fringe benefits described here.[101] Indeed, only two of the foregoing exclusions are possible candidates for application, namely, working condition fringes and de minimis fringes.

Code section 132(d) defines "working condition fringe" as "any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such

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Corridor outside Boston.").

98. I.R.C. § 61(a) (2012).

99. *Id.* § 132(a).

100. *Id.* § 132(a)(1)–(8).

101. Although perhaps not immediately apparent from their respective labels, "no-additional-cost services" and "qualified employee discounts" are not relevant to the types of benefits at issue in this analysis, which generally involve third-party providers. No-additional-cost services involve services that are otherwise provided in the ordinary course of the employer's business (e.g., air travel provided by an airline). *See id.* § 132(b). Qualified employee discounts similarly involve discounts on goods or services provided in the ordinary course of the employer's business (e.g., a merchandise discount provided to employees of the store in which the merchandise is sold). *Id.* § 132(c).

payment would be allowable as a deduction [as an ordinary and necessary business expense, or it would be depreciable]."[102] As expressed in the legislative history, common examples of working condition fringe benefits include magazine subscriptions, personal bodyguards for security reasons, and on-the-job training classes.[103]

Code section 132(e) defines "de minimis fringe" as "any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable."[104] Common examples of excludable de minimis fringe benefits include "occasional cocktail parties, group meals, or picnics for employees and their guests; [and] traditional birthday or holiday gifts of property (not cash) with low fair market value."[105] Common examples of benefits that would not qualify as de minimis fringe benefits include "season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than one day a month; [and] membership in a private country club or athletic facility."[106]

With the foregoing analytical framework in mind, we consider whether Code section 132(d) (working condition fringes) or 132(e) (de minimis fringes) excludes from income the modern fringe benefits described in the prior section.

102. *Id.* § 132(d).

103. H.R. REP. NO. 98-432, at 1601–02 (1984).

104. The Treasury regulations posit two ways in which frequency should be measured. The first is "[e]mployee-measured frequency." Treas. Reg. § 1.132-6(b)(1) (as amended in 1992). Under this test, what each individual employee receives from the employer is measured. For example, if one employee out of a hundred always receives lunch daily, its value is not de minimis because of the frequency with which lunch is received, albeit, as measured by the entire workforce, such meals are infrequently provided. The second frequency test is "[e]mployer-measured frequency." *Id.* § 1.132-6(b)(2). This test may only be utilized if, due to administrative tracking burdens, the "[e]mployee-measured frequency" test is unavailable. *Id.*; *see also* Memorandum from Jerry E. Holmes, Chief, Emp't Tax Branch 2, Dep't of the Treasury, Internal Revenue Serv. (Dec. 31, 2001), https://www.irs.gov/pub/irs-wd/0219005.pdf [https://perma.cc/3CKC-B36H]. Under this second test, what is measured is the frequency with which an employer provides goods and/or services to its employees, taking into account the size of the entire workforce. Thus, if a photocopy machine is restricted to general business use and one employee out of a hundred frequently makes copies on his family's behalf, his use would still qualify as de minimis in nature because, from the employer's vantage point, there is infrequent overall employee use. Treas. Reg. § 1.132-6(b)(2).

105. Treas. Reg. § 1.132-6(e)(1).

106. *Id.* § 1.132-6(e)(2).

1. Customer Loyalty Programs

First, consider the nature of customer loyalty programs. These programs award frequent-flier miles, hotel rewards points, and rental car bonuses. On the one hand, if employees are mandated to use these program benefits to lessen future business-related expenses, such benefits do not constitute taxable income to employees.[107] To illustrate, suppose that an employee takes four business trips to the United Kingdom and, by doing so, earns enough frequent-flier miles, hotel rewards points, and rental car bonuses so that on his next business trip to Paris (or anywhere else in the world) he can fly, sleep, and drive for free. Notwithstanding the receipt of these free benefits, there is no personal inurement and hence no taxable income. Put somewhat differently, these "free" benefits reduce the operating expenses of the business enterprise; and, as such, the initial four purchases combined with the fifth free trip constitute nothing other than a bargain purchase for the employer.[108]

On the other hand, when employees are given free rein and can use customer loyalty programs for their personal benefit, a different tax outcome results. More specifically, suppose in the prior example that the employee uses the customer loyalty program to his advantage so that his next trip is a personal vacation for himself and his wife, where they each enjoy a free flight to Paris, free hotel stay while there, and the free use of a rental car to cruise the Champs-Élysées. None of these benefits fall within the exclusions found in Code section 132. In particular, they are not working condition fringe benefits because had the employee himself utilized his own funds for such expenditures, they would not have been deductible as ordinary and necessary business expenses.[109] Moreover, due to their relatively high fair market value, the airfare, hotel, and rental car do not fall within the scope of de minimis fringe benefits.[110] Since no fringe benefit exclusion applies, the fair market value of these benefits should be included in the employee's gross income.[111]

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107. *See* Rev. Rul. 76-96, 1976-1 C.B. 23; JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 71–73 (2d ed. 1999) (explaining the tax-free nature of "commercial bargain purchases").

108. *See supra* note 107.

109. I.R.C. § 132(d) (2012). Amounts spent on a vacation generally would be considered nondeductible personal expenses. *See id.* § 262.

110. *Id.* § 132(e).

111. *Id.* § 61(a).

2. *Mixed-Use Goods and Services*

Next, consider situations where, as part of their employment package, employees receive a smartphone and home internet service. From an employer's perspective, this often makes incontrovertible business sense: at virtually all times, employees can be readily reached by the employer and/or clients. Conversely, employees can keep their employers and/or clients apprised of existing or prospective business. Because the costs associated with smartphone and home internet service use are ordinarily fixed, employers generally will be indifferent if and when employees use such items for their personal use.

The question becomes thus: if an employee uses his smartphone and home internet service for personal use, say forty percent of the time, what should be the concomitant tax consequences? Had the employee independently secured a smartphone, the associated fees would likely have been at least \$100 monthly, or \$1200 annually.[112] Internet access can range from \$30 to over \$300 per month, depending on the speed (up to \$3600 annually).[113] Because the employer bears this expense, there has been an accretion to the employee's wealth and, accordingly, the possibility of taxable income.

In trying to ascertain the tax consequences associated with the receipt of these benefits, their respective business and personal uses should be considered separately. Consider again the example of an employee who uses her employer-provided cell phone for personal purposes forty percent of the time and for work purposes sixty percent of the time. The portion of the phone expense attributable to work use (i.e., sixty percent of the total annual cost) should be a nontaxable working condition fringe benefit under section 132 because if the employee had paid for the work use directly, she could deduct it as a business expense.[114]

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112. *See, e.g.*, Jon Brodkin, *Verizon Leads Top Wireless Carriers in Bill Size, at Least \$148 a Month*, ARS TECHNICA (Jan. 15, 2014), http://arstechnica.com/business/2014/01/verizon-leads-top-wireless-carriers-in-bill-size-at-148-a-month [https://perma.cc/F9RK-PM9C] (explaining the average individual iPhone plan costs \$104 per month; average for other smartphones is \$94 per month).

113. *See* NICK RUSSO ET AL., OPEN TECH. INST., THE COST OF CONNECTIVITY 2014, at 12 fig.1 (2014), https://static.newamerica.org/attachments/229-the-cost-of-connectivity-2014/OTI_The_Cost_of_Connectivity_2014.pdf [https://perma.cc/L745-85TW]; *see also* Fung, *supra* note 88; Yi, *supra* note 88.

114. Generally, a taxpayer must provide some evidence showing which portion of a mixed-use cell phone or internet service was allocable to business activity and may take a business deduction for that portion. Recently, a taxpayer attempted to deduct his entire cellular phone bill for 2010 of \$2478 despite the fact that he, his wife, and their two children were also on the plan. Kaminski v. Comm'r, No. 21119-13S, T.C. Summ. Op. 2015-7. He also tried to deduct his \$636 internet bill that

As for the personal portion of the phone or internet use, there are two possible approaches, one of which is pro-taxpayer and the other of which is pro-government. Under the pro-taxpayer approach, the personal use of the phone and internet would constitute a de minimis fringe benefit because the use is occasional. The IRS has adopted this pro-taxpayer position in the case of certain employer-provided cell phones (but not internet service).[115] Specifically, the IRS has issued guidance stating that it will treat the business use of the cell phone as a working condition fringe and the personal use as a de minimis fringe, as long the phone was provided for noncompensatory reasons such as ensuring that the employer or clients can reach the employee outside of normal work hours.[116] The pro-government approach would be to argue that while the business use of both the telephone and internet service constitutes a working condition fringe benefit, their frequent personal use combined with their significant fair market value disqualifies them from constituting de minimis fringe benefits.[117] As such, a percentage of the fair market value of each item equal to personal use time should be includable in the employee's income.[118] We explore this approach in depth in Part III.

3. *Lifestyle Enhancements*

Finally, consider the income tax consequences of certain on-the-job comforts and entertainment such as concierge services, personal massages, and access to dance lessons and bowling alleys. Had the employee made such purchases, they would not qualify as ordinary and necessary business expenses; and, as such, they would not qualify as working condition fringe benefits.[119] Whether these sorts of fringe

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provided home access. *Id.* The Commissioner allowed the taxpayer to deduct seventy-five percent of the internet cost and twenty-five percent of the phone bill. *Id.*

Notably, cell phones are no longer subject to the substantiation requirements of Code section 274(d), which contain more onerous recordkeeping requirements for taxpayers to deduct certain types of business expenses (e.g., business travel and entertainment expenses). Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2043, 124 Stat. 2504, 2560 (removing cell phones from the definition of "listed property" under Code section 280F(d)(4)).

115. *See* I.R.S. Notice 2011-72, 2011-36 I.R.B. 407 (allowing personal use of a cell phone to constitute a de minimis fringe benefit as long as the cell phone is primarily noncompensatory in nature).

116. *Id.* On the other hand, the notice does not apply to phones offered to promote employee morale, attract prospective hires, or furnish additional compensation. *Id.*

117. *See supra* note 104 and accompanying text.

118. I.R.C. § 61(a) (2012).

119. *See id.* § 132(d).

benefits can qualify as de minimis is another issue. In some cases, they should qualify; for example, even if a company regularly offers its employees cappuccino instead of plain coffee, there is little doubt that the IRS would classify such a benefit as de minimis.[120] In contrast, if a company regularly offers employees certain other benefits (e.g., haircuts, dance lessons, or concierge services) that are (1) valuable, (2) frequently utilized by particular employees, or (3) frequently utilized by a large segment of the employer's employees, those benefits will not fall within the ambit of de minimis fringe benefits exempt from taxation.[121]

In sum, a close examination of today's fringe benefit offerings strongly suggests that the vast majority constitute gross income and that no exclusion exempts them from taxation.

Admittedly, there is a line of cases in which economic benefits inure to taxpayers that are not specifically excluded from income under Code section 132 but are nevertheless deemed not taxable.[122] For example, in *United States v. Gotcher*,[123] an employer sent an employee on a scouting mission to Germany to determine whether a capital investment in a Volkswagen franchise was worthwhile. While in Germany, the vast majority of the employee's time was apparently spent engaged in business (i.e., investigating the viability of the franchise purchase), but the employee also spent part of his trip touring the German countryside.[124] The Fifth Circuit held that these touring junkets constituted inconsequential economic benefits and, as such, were not taxable, declaring that "some economic gains, though not specifically excluded from section 61, may nevertheless escape taxation."[125]

But the inconsequential economic benefits involved in *Gotcher* are readily distinguishable from the modern fringe benefits described in this Article. With respect to the benefits described in such cases, the marginal economic utility that the employees were able to command was truly an unintended by-product associated with the business objectives

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120. *See supra* note 105 and accompanying text.

121. *See supra* note 104 and accompanying text.

122. *See, e.g.*, Townsend Indus., Inc. v. United States, 342 F.3d 890 (8th Cir. 2003) (finding that employer-provided fishing trip did not constitute income to employees because the primary thrust of the trip was business related); People's Life Ins. Co. v. United States, 373 F.2d 924 (Ct. Cl. 1967) (finding that since the trip's training aspects predominated its vacation aspects, the economic benefit that inured to employees did not constitute wages).

123. 401 F.2d 118 (5th Cir. 1968).

124. *See id.* at 122.

125. *Id.* at 124. However, Gotcher was taxed on the value of the trip expenses attributable to his wife, for whom "the trip was primarily a vacation." *Id.*

that the employer in question sought to achieve.[126] In contrast, today's modern fringe benefits are, for the most part, wholly unrelated to the employer's economic objectives and easily segregated therefrom.

C. Why Modern Fringe Benefits Are Often Not Reported

Despite the fact that modern fringe benefits (which were largely unknown until the turn of this century) should be subject to income tax,[127] there are a number of reasons why taxpayers may fail to report these fringe benefits for tax purposes. Possible factors include the following: (1) the valuation of such fringe benefits is inherently problematic; (2) recordkeeping could prove administratively burdensome; (3) their "tax-free status" has tremendous popular and political support; and, (4) over the past quarter of a century, payroll taxes have significantly risen, making noncompliance more attractive. One or more of these factors likely play a pivotal role in the practice of taxpayers not reporting the receipt of these benefits.

1. Problematic Valuation

Consider first the issue of valuation. Taxable benefits are generally easy to quantify. If a taxpayer performs a service and is paid $1000 in cash, then the Code taxes the $1000 as income.[128] Similarly, if a taxpayer performs the same services and is paid in-kind (e.g., with a television worth $1000), the Code taxes the in-kind payment as $1000 of income.[129]

Much more challenging are circumstances in which payments are made in-kind with assets that have a fair market value that is hard or virtually impossible to ascertain. A case in point is frequent-flier miles. The fair market value of these miles depends upon a whole host of important factors, including the generosity of the plan itself (i.e., how many miles must be redeemed to secure a particular trip), the time in the

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126. This issue is somewhat similar in nature to what are known as Kleinwächter's conundrums, presented in HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 43 (1938). The most famous of these conundrums involves a Flügeladjutant, or military attaché, who, as a condition of his employment, must attend the theater and opera with the emperor. As a result of attending these entertainment events, would the Flügeladjutant derive income? Simons labeled the answer to this question as "clearly hopeless," *id.* at 53, but this series of cases, *see supra* note 122, and *Gotcher* instruct taxpayers to treat the inconsequential economic benefits deriving from certain employment events as nontaxable.

127. I.R.C. § 61(a) (2012).

128. *Id.*

129. Treas. Reg. § 1.61-2(d) (as amended in 2003).

calendar year when the benefit is redeemed, and the proximity in time to the scheduled flight when the reservation is made.[130] Translated into dollars and cents, several studies indicate a wide disparity in the fair market value of frequent-flier miles: they are purportedly worth as little as a penny or as much as a nickel.[131] A typical employer would not know how to pinpoint this value. If an employer assumed the fair market value of each mile to be one cent, the income of many employees might be undertaxed; conversely, if an employer assumed the fair market value of each mile to be five cents, the income of many employees would be overtaxed. The timing of the inclusion in income is also problematic: is it upon receipt of the miles, when the reservation is made, or when the flight is taken?

Many of the issues regarding frequent-flier miles likewise hold true with respect to the other customer loyalty program benefits that this analysis describes (e.g., hotel rewards programs and rental car bonus upgrades)—in other words, ascertaining their fair market values is fraught with great difficulty, and timing inclusion concerns abound.[132]

2. Burdensome Recordkeeping

Next, consider the recordkeeping challenges associated with tracking the receipt of many modern fringe benefits. By way of background, consider the fact that the Treasury regulations generally do not require that taxpayers track the receipt of de minimis fringe benefits if the burdens of tracking such benefits outweigh their projected revenue.[133] The quintessential example of such a de minimis fringe benefit is attendance at an occasional employer-provided cocktail party; no one realistically expects that the bartender should record each drink that an employee orders and, at the end of the event, issue a drink-tally report to the employer or the employee. The revenue associated with taxing these drinks would not be worth the administrative recordkeeping burden.

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130. *See infra* notes 150–60 and accompanying text.

131. Ed Perkins, *Frequent Flyer Miles: A Close Look*, CHI. TRIB. (Aug. 6, 2013), http://articles.chicagotribune.com/2013-08-06/lifestyle/sns-201308060000—tms—travelpkctnxf-a20130806-20130806_1_1-8-cents-award-seats-premium-seats [https://perma.cc/Z5ZY-HAT9].

132. Consider hotel points, which are frequently subject to restrictions not unlike those applicable to airline miles. For example, the type of room or upgrade that can be purchased with a certain amount of points may vary based on availability at the time of purchase, or the time of the year. *See, e.g.*, *Frequently Asked Questions*, HILTON HHONORS, http://hhonors3.hilton.com/en/support/faq/index.html#hotelrewards [https://perma.cc/YWP6-SW9U] (last visited Apr. 15, 2016) (discussing restrictions applicable to Hilton hotel points).

133. *See* Treas. Reg. § 1.132-6(c) (as amended in 1992).

Such administrative challenges hold true with respect to many other fringe benefits as well. For example, with respect to employees who use their employer-provided cell phones and home internet service for personal use, it would be intrusive for employers to monitor and burdensome to employees to record such usage.

3. Political Support for Tax-Free Status

Today's fringe benefits also garner tremendous popular and political support. Such benefits have become ubiquitous and deeply entrenched as an essential feature of the nation's economic fabric.

Consider a recent case in point. As a marketing ploy, Citibank offered potential customers frequent-flier miles if they opened up new deposit accounts.[134] Those taxpayers who, on the basis of this offer, opened bank accounts and received frequent-flier miles were surprised to learn that Citibank treated the frequent-flier miles, valued at 2.5 cents per mile, as a form of taxable interest and reported it on each customer's annual Form 1099.[135] This tax treatment created a firestorm of controversy as politicians from both sides of the political aisle rushed to denounce Citibank's tax treatment of such miles,[136] even though Citibank was on sound statutory footing.[137]

The Citibank uproar is not an isolated incident.[138] On many occasions, popular and political support for the current tax treatment of third-party-provided fringe benefits has been quite vocal.[139]

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134. Martha C. White, *Income Taxes on Frequent Flyer Miles?!*, TIME (Jan. 30, 2012), http://business.time.com/2012/01/30/citi-customers-learn-bonus-airline-miles-have-a-high-price/ [https://perma.cc/G83R-NLPR].

135. *Id.*

136. *See, e.g.*, Alistair M. Nevius, *Are Frequent Flyer Miles Taxable?*, J. ACCT. (July 31, 2012), http://www.journalofaccountancy.com/Issues/2012/Aug/20125796.htm [https://perma.cc/F5HE-HVCJ] ("Sen. Sherrod Brown, D-Ohio, wrote Citibank to reprimand it and ask it to discontinue the practice.").

137. I.R.C. § 61(a) (2012).

138. *See, e.g.*, Lawrence A. Zelenak & Martin J. McMahon Jr., *Taxing Baseballs and Other Found Property*, 84 TAX NOTES 1299, 1299–300 (1999) (explaining why many politicians, reflecting public sentiment, made it clear that record-breaking home-run baseballs should not be taxed).

A more cynical reason why many politicians are such staunch defenders of retaining the tax-free status of third-party fringe benefits is that the recipients of such benefits are well-to-do economically and have used their bountiful financial resources to lobby politicians on their behalf. *See* Edward J. McCaffery & Linda Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159 (2006) (explaining how politicians use the threat of taxes to attract campaign funds).

139. *See, e.g.*, JP Mangalindan, *A Tax on Free Meals? Silicon Valley Says 'Bad Idea,'* FORTUNE

This popular and political support has engendered an environment in which taxpayers—both employers and employees—exist in self-imposed ignorance regarding the dispensing and receipt of fringe benefits. Employers who do not report these kinds of fringe benefits understand that this is not an issue that IRS auditors generally raise,[140] and many employees subscribe to the notion that they must report only what is on their Form W-2. The combination of the employer's mentality that "the less it tells, the better" and the employees' mentality that "the less they know, the better" has left a vast void when it comes to the reporting of these fringe benefits.

4. Increased Payroll Taxes

Finally, over the last several years, payroll taxes have become more burdensome. The two most significant payroll increases were in 1993 and 2010. In 1993, Congress passed legislation that removed the wage cap associated with the application of the 2.9% Medicare tax[141] so that all wages are now subject to this payroll tax. More recently, as part of the Affordable Care Act, so-called high-income workers pay an additional Medicare tax equal to 0.9% of earnings above certain unindexed thresholds: $200,000 for single taxpayers and $250,000 for the combined earnings of married taxpayers.[142] Offering tax-free fringe benefits mitigates the burdens of these increased payroll taxes and thereby enhances their attractiveness.

D. The Current Landscape

The reasons for taxpayer noncompliance are, quite obviously, plentiful, which bodes poorly for a tax system that historically relies

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(Sept. 2, 2014, 8:25 PM), http://fortune.com/2014/09/02/a-tax-on-free-meals-silicon-valley-reacts/ [https://perma.cc/3CE3-VWV8] ("News of a potential tax on free meals has many worried in Silicon Valley, where all-you-can eat buffets are a basic recruiting tool.").

140. IRS agents harbor a self-interest in not aggressively pursuing taxpayers who receive promotional benefits and treating them as taxable income since the *Internal Revenue Manual* specifically states the following: "Counsel employees may retain for personal use promotional items received during the course of an official business trip if such items are obtained under the same conditions as those offered to the general public at no additional cost to the Government." INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL ¶ 30.5.2.6 (2007), https://www.irs.gov/irm/part30/irm_30-005-002.html#d0e620 [https://perma.cc/37P7-2PEL].

141. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13207, 107 Stat. 312, 467–68.

142. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9015, 124 Stat. 119, 870–71 (2010), *amended by* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1411, 124 Stat. 1029, 1061–63 (codified at 26 U.S.C. § 3101(b) (2012)).

heavily upon accurate taxpayer self-reporting. Thus, it is important to explore those avenues of reform that Congress should consider in order to bolster taxpayer compliance.

For many reasons, reforming this area of the law is challenging. For years, taxpayers have become acclimated to not paying taxes on many fringe benefits. They and the politicians that represent them are thus unlikely to readily concede that such benefits are taxable; indeed, they will likely argue that many hurdles, such as valuation and administrative recordkeeping, make the taxation of such benefits impossible. This is not a problem that is unique to the United States, either. Other industrial countries that rely upon income tax systems for revenue are encountering the same difficult issue of trying to tax third-party-provided fringe benefits, and, to date, no such nation has developed an approach that puts this issue to rest; instead, each appears to endure this problem in its own stoic fashion.[143]

For the time being, the IRS has responded to some, though not all, of these issues in an ad hoc fashion. With respect to frequent-flier miles and similar promotional benefits earned through business travel, the IRS has declared that, in the absence of congressional direction, it will not take any enforcement action against taxpayers who use these benefits for personal purposes.[144] The IRS has also taken the position that personal use of cell phones provided by employers primarily for business purposes constitutes a de minimis fringe.[145] Finally, though the IRS has remained silent on the issue of lifestyle enhancements to date, the Treasury and the IRS have put "[g]uidance under [sections] 119 and 132 regarding employer-provided meals" on their 2014–2015 Priority Guidance Plan.[146]

That the IRS has staked out a position with respect to any of these benefits should leave elected officials from both sides of the political aisle uneasy. On the right, politicians should be aghast that an unelected administrative agency—particularly one that they detest[147]—has been

143. *See generally* Lawrence Zelenak, *Up in the Air over Frequent Flyer Benefits: The American, Canadian, and Australian Experiences*, 9 CAPITAL MARKETS L.J. 420, 421 (2014) ("Virtually no tax on frequent flyer benefits is collected anywhere, and respect for the rule of law . . . has been eroded.").

144. I.R.S. Announcement 2002-18, 2002-10 I.R.B. 621.

145. *See* I.R.S. Notice 2011-72, 2011-36 I.R.B. 407.

146. DEP'T OF THE TREASURY, 2014–2015 PRIORITY GUIDANCE PLAN 10 (2015), http://www.irs.gov/pub/irs-utl/2014-2015_pgp_3rd_quarter_update.pdf [https://perma.cc/2ZDL-8N6D].

147. *See, e.g.*, Doyle McManus, *Republicans Love to Hate the IRS, but It's a Model of Efficiency*, L.A. TIMES (Mar. 31, 2015), http://www.latimes.com/opinion/op-ed/la-oe-0401-mcmanus-irs-

tacitly permitted to establish de facto law. On the left, politicians should be aghast that billions of dollars of fringe benefits, inuring predominantly to the wealthy,[148] escape any taxation.

III. FRINGE BENEFIT TAX REFORM

The solution to fringe benefit tax reform lies in congressional attention to this matter. This Part looks first at guiding principles that should assist Congress in formulating reform measures and, second, at the application of these principles to the specific categories of modern fringe benefits discussed herein: customer loyalty programs, mixed-use assets, and lifestyle enhancements.

A. Guiding Principles

Before discussing potential approaches to taxing specific fringe benefits, we consider the following guiding principles for reform.

1. Valuation

First, consider valuation. When valuing fringe benefits is administratively burdensome and little tax revenue is at stake, such benefits should be excluded from employees' income. In those circumstances, the cost to either the employer or the employee of having to value the benefit, along with additional administrative cost to the IRS of enforcing proper valuation, likely outweighs any financial benefit to the government.

But difficult valuation alone does not justify exempting fringe benefits from taxation, particularly when there is significant tax revenue at stake. In such cases, policymakers should require income inclusion and rely on proxy values or formulas that would be simple and efficient to administer. Political or fairness concerns about inaccuracy can be

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20150401-column.html [https://perma.cc/QYX8-SUBW].

148. *See, e.g.*, Frances Dinkelspiel, *With High-End Meal Perks, Facebook Keeps Up Valley Tradition*, N.Y. TIMES (Dec. 25, 2009), http://www.nytimes.com/2009/12/25/us/25sfcafeteria.html?pagewanted=all [https://perma.cc/66M8-DDB8] ("On one day, the menu may feature Thai-spiced cilantro chicken or salmon with red curry sauce. On another, there may be roasted quail, a variety of chocolate-infused treats or the signature dishes of some of the top chefs of New York."); Rachel Feintzeig, *Lavish Perks Spawn New Job Category*, WALL ST. J. (Nov. 20, 2014), http://www.wsj.com/articles/lavish-perks-spawn-new-job-category-1416529198 [https://perma.cc/VZN2-HYMD] ("Asana spends tens of thousands of dollars a year per employee on perks, which [the company's chief operating officer] says is 'easily' equivalent to between 10% and 15% of salaries. [Pinterest] . . . says it spends $10 to $12 for each employee lunch or dinner—and $10 a person for the once-a-week hot breakfast.").

addressed by choosing proxies or formulas that err toward being taxpayer friendly. For example, as discussed below, frequent-flyer miles should be valued at a fixed amount per mile based on a low-end estimate of their fair market value. Although adopting taxpayer-friendly valuation rules may leave tax revenue on the table, it is far preferable to exempting hard-to-value fringes from tax, which not only collects zero revenue but also reinforces the faulty perception that noncash compensation is free from tax. The Code taxes hard-to-value property and services in other contexts,[149] and valuable fringe benefits should not be an exception.

2. Recordkeeping

Next, consider the recordkeeping challenges associated with the receipt of some fringe benefits. Certain goods or services may be relatively easy to value but difficult to track. This is particularly true of benefits with a mixed business/personal element. For example, although the value of cell phone service provided by a third party is not difficult to ascertain, tracking an employee's business versus personal use of the phone may be difficult. Like valuation, the cost of arduous recordkeeping may outweigh the benefit of taxing certain benefits if little tax revenue is at stake. However, for fringe benefits that represent significant compensation to employees, recordkeeping challenges do not justify exempting such benefits from tax. In many instances, these challenges can be overcome by relying on fixed allocations between business and personal benefits in lieu of tracking employees' actual personal consumption. For example, as discussed below, fifty percent of the value of an employer-provided cell phone could be taxed to employees as compensation.[150]

Consider further the fact that certain other fringe benefits may be difficult to track on an employee-by-employee basis, yet the employer's collective costs may be relatively simple to track. For example, an employer might provide free on-site yoga classes on a weekly basis for any employee who wishes to participate. While keeping track of which employees attend yoga week-to-week would be somewhat burdensome, tracking the employer's costs for hiring a yoga teacher and providing facilities would be comparatively simple. In such circumstances, denying an employer deduction for costs is preferable to taxing

149. For example, regulations under section 482 of the Code provide extensive rules for valuing intangible property transferred between certain related parties. *See* Treas. Reg. § 1.482-4 (as amended in 2011).

150. *See infra* Section III.C.

employees on the benefit.[151]

3. *Public Perception/Politics*

Another consideration is public perception and politics. While any attempt to tax fringe benefits that have been largely ignored until now will be met with marginal resistance, some reforms may be more or less popular than others. Taxation of benefits that are generally not perceived to be income by taxpayers, or benefits that taxpayers are unable to opt out of, will be particularly unpopular. In cases where taxing employees on certain fringe benefits would be particularly unpalatable, policymakers should consider denying employer deductions instead.

4. *Information Returns*

Finally, in those instances where taxation is warranted and in order to bolster compliance, we contend that Congress should require information returns to be provided to fringe benefit recipients. For benefits offered directly by employers, current withholding and information-reporting requirements for wages should apply; in the case of fringe benefits provided by third parties, Congress should require information reporting by those third parties if they are in the best position to track and disseminate information regarding the benefits.

Applying the foregoing principles and using our prior categorizations[152]—customer loyalty programs, mixed-use goods and services, and workplace lifestyle enhancements—we explore the appropriate tax consequences associated with the receipt of each fringe benefit. Depending upon the nature of the benefit being dispensed, we determine that they should be (1) included in employee income, (2) excluded from employee income, or (3) excluded from employee income coupled with a denial of a deduction for the employer.

B. *Taxing Customer Loyalty Program Benefits*

Customer loyalty programs generally should result in their

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151. There is, of course, a potential accuracy trade-off that comes with denying an employer deduction as opposed to taxing benefits at fair market value. For example, employers with net operating losses or very low effective tax rates would experience little or no impact from losing a deduction, and there would be little or no associated revenue gain. However, in cases where tracking employer costs is significantly easier than tracking employee benefits, or where taxing employees would be politically impracticable, this potential trade-off can be justified.

152. *See supra* Section II.A.

participants accruing taxable income[153] when, as is commonly the case, the benefits are earned in the business context and subsequently utilized for unrelated personal consumption. Customer loyalty points should be valued based on a fixed amount per point and included in income at the time that they are redeemed for personal consumption.

We draw this conclusion for several reasons. First, as discussed above in Part III, customer rewards earned from business travel and redeemed for personal use clearly constitute gross income to the employee under the tax law.[154] For example, an employee who earns frequent-flier miles through business travel paid for by her employer, and who later uses those miles to take a vacation to Hawaii, has clearly realized an accession to wealth.[155] Second, in considering the three options discussed above (exclude from income, include in income, or deny employer deduction), income inclusion is most appropriate in this context. Recordkeeping costs are minimal because airlines, hotels, and other similar third parties already keep electronic records of customer loyalty points. Additionally, the revenue at stake is substantial;[156] thus, there is little justification here for an exclusion from income. Finally, employers do not incur additional out-of-pocket costs[157] for customer loyalty points that their employees accrue, so denying a deduction that would represent the cost of the benefit is not a viable option.

The biggest challenges presented by customer loyalty programs are valuation and timing. Consider again the example of an employee who redeems frequent-flier miles earned through business travel for a flight to Alabama. To tax her on the benefit received, policymakers must determine how to value the benefit and when to require the income inclusion. As to valuation, the "correct" result under the tax law would be to tax the employee on the fair market value of the airline ticket that she purchased with her frequent-flier miles.[158] However, determining

153. An exception is office supply coupons, which should be excluded from taxation, as discussed further below.

154. On the other hand, redeeming points earned through personal travel paid for by the taxpayer would not result in taxable income. *See supra* note 68.

155. *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).

156. *See supra* note 80 and accompanying text. Zelenak estimates forgone revenue from not taxing frequent-flier benefits to be in the range of $1.5 billion per year. Zelenak, *supra* note 143, at 2.

157. It is possible that the value of customer loyalty points is built into the price of the services that generate those points, but determining what portion of that value is assignable to the points is impractical. Generally, the market price of a service with or without customer loyalty membership is the same.

158. Treas. Reg. § 1.61-2(d) (as amended in 2003).

this fair market value may be difficult with respect to an individual ticket and, even if this fair market value could be determined with reasonable accuracy, adopting a case-by-case valuation would be administratively costly.

One option that would attempt to approximate fair market valuation of frequent-flier miles would be to tax the employee on an amount equal to the cost of a comparable airline ticket purchased for cash, i.e., a ticket on the same flight that is in the same class (economy versus business, for example) and that is subject to the same restrictions.[159] In theory, an airline might be able to provide this value with relative ease using a computer program. However, it is likely that, in most cases, comparable tickets do not exist[160]: tickets purchased with frequent-flier miles tend to be subject to more restrictions than tickets purchased for cash, and tickets with more restrictions are generally cheaper than unrestricted tickets or tickets with fewer restrictions.[161] Thus, even the most heavily discounted economy fare is likely worth more than an economy class ticket purchased with frequent-flier miles. Additionally, even if airlines could provide the value of a comparable ticket relatively simply, the process of having to value rewards points on a flight-by-flight basis might be too burdensome to justify the cost.

Treasury regulations applicable to airline employees suggest another approach to valuing "free" flights.[162] Under the relevant rules, airline

159. A comparable approach was taken by the Tax Court of Canada in *Mommersteeg v. The Queen*, 96 D.T.C. 1011 (1995). *See also* Zelenak, *supra* note 143, at 428–29 (discussing *Mommersteeg*). In *Mommersteeg*, the taxpayers had used frequent-flier miles earned through business travel to purchase airline tickets. 96 D.T.C. at 1011–12. The court held that, ideally, the "reward tickets" should be valued at the price of a ticket on the same flight in the same class and subject to the same restrictions. *Id.* at 1016. However, the reward tickets on the relevant flights were heavily restricted, while first and business class tickets purchased for cash were unrestricted. *Id.* at 1016–17. Thus, the court discounted the amount includable in income, holding that "the value of a reward ticket in either business or first class is equal to that proportion of an unrestricted business or first class fare which the price of the most heavily discounted economy class fare on that flight is of the price of a full fare economy class ticket." *Id.* at 1017. Zelenak notes that the Canadian Revenue Agency has generally not made any attempt to enforce the taxability of frequent-flier miles subsequent to the decision in *Mommersteeg*. Zelenak, *supra* note 143, at 429 ("Despite the [Canadian Revenue Authority's (CRA)] judicial victory, there is no indication that the CRA is making any meaningful attempt to enforce the taxability of frequent flyer rewards.").

160. *See Mommersteeg*, 96 D.T.C. at 1014; George Guttman, *IRS Moves Slowly on Frequent Flyer Issue*, 38 TAX NOTES 1309, 1312 (1988); Zelenak, *supra* note 143, at 429.

161. *See, e.g.*, *Mommersteeg*, 96 D.T.C. at 1014 ("Restrictions may relate to the time when the ticket must be issued, flexibility of travel, for example, advance booking requirements and the ability to change the itinerary, the availability of refund if a ticket is not used, length of stay at destination and season in which travel is to take place. A major restriction relates to the number of tickets made available at each price level.").

162. *See* Treas. Reg. § 1.61-21(h) (as amended in 2012).

employees who fly standby (free of charge) on certain commercial flights are taxed on twenty-five percent of the airline's highest unrestricted coach fare for that flight.[163] It is unclear how this approach to valuation would relate to an ideal fair market value for a ticket purchased with frequent-flier miles.[164] On the one hand, limiting the valuation to twenty-five percent of the coach fare may result in undervaluation. On the other hand, basing the calculation on an unrestricted fare might overvalue a highly restricted ticket purchased with frequent-flier miles, even with the seventy-five percent discount. In any case, application of this Treasury rule (which generally applies in very limited circumstances)[165] requires the administratively burdensome task of determining the highest unrestricted coach fare for each relevant flight.

A far better approach is to simply place a flat dollar value on each "mile" or "point" earned through a customer loyalty program. For example, each frequent-flier mile might be valued at one cent initially[166] and adjusted periodically for inflation.[167] Customer loyalty points for other types of programs like hotels or rental cars could be valued in a similar manner. While no single value would accurately capture the fair market value of each kind of benefit, the simplicity of choosing a flat amount justifies such an approach. To avoid fairness concerns surrounding overtaxing employees, policymakers should choose an amount on the low-end of the estimated value range. Thus, one cent per mile would likely undervalue many frequent-flier benefits, which have

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163. *Id.* § 1.61-21(h)(1).

164. *Id.* The amount is includable on the date that the flight is taken. *Id.* § 1.61-21(h)(4).

165. Standby flights offered by airlines to their employees are generally excludable fringe benefits under section 132 as long as the benefit qualifies as a "no-additional-cost service" (e.g., the flight was not otherwise full and thus there is no forgone revenue). *See* BLOOMBERG BNA, TAX MANAGEMENT PORTFOLIOS: EMPLOYEE FRINGE BENEFITS, NO. 394-5TH, at A-23. The valuation rule under Treas. Reg. § 1.61-21(h) generally applies to no-additional-cost services offered to airline employees by an airline *other* than the employee's employer, which otherwise would not qualify under section 132. *Id.* at A-68.

166. Zelenak suggests a valuation in the range of $0.008 to $0.010 per mile. *See* Zelenak, *supra* note 143, at 441. The valuation of frequent-flier miles may reach new levels of obscurity. *See* Ron Lieber, *Guesswork in Cashing in Delta's Frequent-Flier Miles*, N.Y. TIMES (July 31, 2015), http://www.nytimes.com/2015/08/01/your-money/in-deltas-frequent-flier-magic-trick-not-just-rabbits-disappear.html?_r=1 [https://perma.cc/U4ZA-59RG] (explaining how the number of miles needed for a free ticket or upgrade under Delta's reengineered rewards program "will change based on destination, demand and other considerations").

167. Like tax bracket dollar thresholds and the amount of the personal exemption and standard deduction, valuations could be adjusted annually via the Treasury and the IRS rather than through the legislative process.

been estimated to be valued between one and six cents per mile,[168] but such a valuation would still generate revenue—and in a politically palatable way. In addition to revenue generation, taxing rewards points at even a minimal value could go a long way toward restoring IRS credibility and promoting taxpayer compliance.

As for the timing of the income inclusion, there is a theoretical case to be made for taxing employees upon the receipt of the miles or points. A taxpayer who has earned points or miles redeemable for valuable benefits has arguably satisfied all the tests for income inclusion under *Commissioner v. Glenshaw Glass Co.*,[169] i.e., an accession to wealth that is clearly realized, over which the taxpayer has complete dominion.[170] On the other hand, rewards points like frequent-flier miles are generally subject to contractual limitations that may point toward no income realization event before they are actually redeemed.[171] In any event, it is likely that taxpayers generally do not perceive that they have received a benefit from the accrual of customer loyalty points until those points are redeemed. For many individuals, points or miles may expire before they are used. For others, restrictions on flights like blackout dates may make miles practicably unusable, while other employees may have no desire to use points earned through business travel for personal purposes. However, when a customer redeems miles or points in exchange for something of value (an airline ticket, for example), the benefit to the taxpayer is clear. To avoid perceptions of unfairness and political backlash, policymakers should establish that customer loyalty points are includable in income at the time that they are redeemed.

Taxing rewards points at a flat dollar amount upon redemption would present some logistical hurdles, but these hurdles are not insurmountable. Consider again the case of frequent-flier miles, and assume, for example, that an employee earned 50,000 miles through work trips paid for by her employer. Further assume that she earned 20,000 miles on personal trips that she paid for herself, bringing her total frequent-flier miles to 70,000. If the employee redeems 30,000 miles to purchase a round-trip coach ticket to Hawaii for vacation, who should be responsible for tracking miles that she accrues on business trips? Furthermore, how should those miles be tracked?

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168. *See supra* note 131 and accompanying text.

169. 348 U.S. 426 (1955).

170. *Id.* at 477.

171. For example, Zelenak notes that airlines' frequent-flier programs typically contain terms and conditions that allow the airline to change or revoke benefits without notice. *See* Zelenak, *supra* note 143, at 437.

Among the employee, her employer, and the airline, the airline is in the best position by far to track the frequent-flier miles. As part of its rewards program, airlines already have the capacity to electronically track miles accrued for each customer, and, thus, no significant additional costs would be incurred. As for employers, they lack the necessary information regarding taxpayers' customer rewards accounts.[172] And while the taxpayers themselves are privy to the necessary information and could keep their own records, compliance is demonstrably lower when there is no third-party reporting.[173] Accordingly, the airlines themselves are the best choice to ensure tax compliance.[174]

Assuming that airlines (or the corresponding rewards provider) would be responsible for tracking taxable miles, separating business and personal miles could be accomplished by requiring customers to indicate, for each trip booked, whether the travel was for "business" or "personal" reasons. For example, when a customer books a flight online using the airline's website, he generally is prompted to enter his frequent-flier number. He could be similarly prompted to make one additional entry by checking a box or choosing from a pull-down menu to indicate whether the trip was business or personal in nature.

Once miles were separated into personal and business accounts, there would need to be a system for allocating miles redeemed for trips. For the same reasons that policymakers should choose a low valuation for taxing frequent-flier miles, they might similarly adopt a taxpayer-friendly approach of allowing personal miles to be applied toward redemption before business miles. In the example above, this would mean that our employee would be treated as having redeemed 20,000 personal miles and 10,000 business miles for her ticket to Hawaii. Accordingly, she would be taxed on $100 of income (10,000 x $0.01). Airlines could then send to taxpayers annual statements on Form 1099

172. *See, e.g.*, Guttman, *supra* note 160, at 1313.

173. *See, e.g.*, Karen Setze, *Taxpayers Honest When Someone's Checking, Say IRS Officials*, 111 TAX NOTES 1216, 1216 (2006) ("[R]esults from the recently completed individual reporting compliance study for 2001 . . . showed that only 1.2 percent of wage income was underreported, 57 percent of nonfarm proprietor income was misreported . . . and 72 percent of farm income was misreported."); INTERNAL REVENUE SERV., TAX GAP FOR TAX YEAR 2006: OVERVIEW, at chart 1 (2012), http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf [https://perma.cc/EHL7-V3KV] (estimating one percent noncompliance rate when income is subject to substantial information reporting and withholding, and eight percent noncompliance rate when income is subject to substantial information reporting but not withholding).

174. *See* Joseph M. Dodge, *How to Tax Frequent Flyer Bonuses*, 48 TAX NOTES 1301, 1302–03 (1990) (proposing that airlines send taxpayers information returns with aggregate numbers (e.g., total award miles used) with the burden on taxpayers to calculate taxable income).

reporting how many business miles had been redeemed during the year and the corresponding amount of taxable income.[175]

Although a shift in the status quo with respect to taxing customer loyalty programs may be met with some resistance initially, taxpayers will still recognize savings from rewards points, and it is highly unlikely that the tax paid would be greater than the amount at which they value the benefit. In the above example, the employee taxpayer recognizes $100 of income upon redemption of miles for a ticket to Hawaii. Assuming that her marginal tax rate is thirty percent, her cost for the ticket is now $30 (instead of zero), which is likely still significantly less expensive than the amount for which she could purchase a flight for cash. And if cash prices for a flight somehow dropped below the employee's "cost"[176] of a taxed flight, she could opt to pay cash instead of using frequent-flier miles. This is the same calculus that many individuals undoubtedly make when deciding whether to purchase relatively cheap flights for cash instead of using frequent-flier miles under the current system.

Another issue that is somewhat unique to customer loyalty programs concerns withholding and payroll taxes. Under current law, employers are generally subject to withholding and payroll tax obligations on taxable fringe benefits.[177] The issue with these benefits, of course, is that the remuneration arguably does not come from the employer but, rather, from the third party. This makes it somewhat unclear whether these benefits actually constitute "wages" for withholding and payroll tax purposes.[178] Employers have a lot at stake if they fail to account

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175. *See* Guttman, *supra* note 160, at 1313 (noting that the IRS has taken the position that it has authority to require airlines to file information reports if the value of the award is at least $600); Zelenak, *supra* note 143, at 444 (arguing that Code section 6041(a) authorizes a requirement for airlines to report frequent-flier miles to taxpayers).

Under current law, information reporting obligations generally are not triggered for payments under $600 (except as otherwise provided by statute). I.R.C. § 6041(a) (2012). Thus, airlines would not have to report taxable business miles that resulted in less than $600 of income. If a low valuation per mile is adopted along with a rule that lets taxpayers use personal miles first, this could effectively exempt a significant number of flights from reporting (as well as exempting other customer loyalty benefits). Accordingly, policymakers should consider instituting a lower reporting threshold for third-party-provided fringe benefits, as it has done for other types of income. *See, e.g.*, *id.* § 6049(a) (setting a $10 threshold for interest payments).

176. The cost to the taxpayer would be the cost per mile (e.g., one cent) multiplied by business miles redeemed multiplied by the employee's marginal tax rate.

177. Employer withholding and payroll tax obligations extend to "wages," defined as all remuneration for services "including the cash value of all remuneration (including benefits) paid in any medium other than cash." I.R.C. §§ 3401(a), 3501(b) (withholding); *see also id.* §§ 3121(a), 3306(b) (Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act).

178. Commentators have come out both ways on this issue. *Compare* Dodge, *supra* note 174, at

accurately for the associated tax consequences. A multilevel set of penalties applies when there is a withholding failure,[179] and another set of penalties applies if accurate information returns are not issued.[180] Thus, any legislative action that clarifies the taxability of customer rewards benefits should similarly clarify employer obligations in this regard.

As discussed above, employers lack the requisite information regarding customer loyalty programs to engage in information reporting or withholding.[181] Although policymakers could impose a requirement that taxpayers keep their employers informed of business-related rewards, this would be costly[182] and likely subject to abuse.[183] A better option would be to treat taxable customer loyalty program points like interest or dividends—amounts that are subject to information reporting but not withholding or payroll taxes. In this case, the information reporting would come from the airlines (or a similar third-party service provider), and the employers would essentially be left out of the equation. Thus, taxpayers would report and pay income tax on amounts reported to them on a Form 1099 by the airline or other relevant third party. Although there would be some revenue lost to the fisc in the form of forgone payroll taxes, this may be a worthy sacrifice to the goal of administrative feasibility.[184] Furthermore, information reporting alone, without withholding, appears to be sufficient to motivate compliance for

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1304 (concluding that frequent-flier miles are not wages because "the benefit comes from the airline, not the employer, and is not earned as compensation for services provided to the employer"), *with* Zelenak, *supra* note 143, at 442 (arguing that airline miles constitute wages because the employer pays for the travel giving rise to the miles and has "the power either to require employees to use their points only on business travel or to prohibit employees from seeking to receive points for employer-paid travel").

179. Employers that are derelict in their responsibilities to withhold bear the following possible consequences: secondary liability for failure to withhold income taxes, I.R.C. § 3403; secondary liability for failure to withhold the employee's share of FICA taxes, *id.* § 3102(b); liability for late deposits on withheld taxes, *id.* § 6656(a); and liability for accuracy-related penalties, *id.* § 6662.

180. *See id.* §§ 6721, 6722.

181. *See* Dodge, *supra* note 174.

182. Requiring employees to track rewards earned from business travel and report them to the employers would be a time-consuming exercise that would largely negate the benefit of shifting information-reporting responsibilities to the airlines.

183. *See, e.g.*, Zelenak, *supra* note 143, at 443.

184. Certainly, some amount of horizontal equity would be compromised as well because income earned in the form of customer loyalty points would not be subject to payroll taxes while cash income (and other fringe benefits) would. However, in the case of highly paid employees, payroll taxes make up only a minor percentage of total taxes paid, so imposing income tax on third-party-provided fringe benefits would still go a long way toward imposing a fairer system.

the vast majority of taxpayers,[185] so the lack of withholding should not have any significant negative effect on overall compliance.

While the foregoing discussion has focused largely on frequent-flier miles, other similar types of customer loyalty programs like hotel and rental car programs should be taxed in the same manner. Benefits from those programs involve the same valuation difficulties, particularly because redeeming hotel or car rental points may also be subject to restrictions, making the cash price for a comparable service hard if not impossible to identify. Thus, a low-end fixed value should be assigned to each point, and taxpayers should be taxed upon redemption. Like airlines, providers of other, similar benefits should be required to issue information returns.

Office supply coupons, on the other hand, should be taxed differently than other types of customer rewards programs. Admittedly, these store coupons typically delineate a specific dollar amount and, thus, do not present nettlesome valuation difficulties. For example, if an employee purchases $100 of office supplies (for which she is reimbursed by her employer) at Staples, she might receive a $10 coupon toward her next Staples purchase. However, while companies like Staples may keep track of cash rewards through online customer accounts,[186] delineating between business and personal purchases in this context would be inherently problematic, particularly since those rewards are far more likely to be redeemed by customers in person. In the context of an in-store purchase, tracking the redemption of those coupons, separating business versus personal coupons, and reporting tax information to customers is a much more complicated task than tracking frequent-flier miles and redemption of customer loyalty points of similar businesses, which in most cases is done online. Further, having a store clerk ascertain whether a taxpayer's purchase of a desk chair using a rewards coupon is for personal or business use would be ridiculous; and relying upon a taxpayer's self-serving assessment in this context may result in a highly suspect judgment call. In light of these administrative difficulties, we concede that office supply coupons (and other, similar cash coupon programs) earned through business purchases should be exempt from taxation for employees who redeem them for personal use. Since the benefits of these purchases do not fall within the scope of any of the

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185. While the noncompliance rate for income subject to both information reporting and withholding is one percent, the rate for income that is subject to substantial information reporting only (and not withholding) is just eight percent, indicating that the vast majority of such income is reported accurately. *See* INTERNAL REVENUE SERV., *supra* note 173, chart 1.

186. *See Staples Rewards Program*, *supra* note 77.

statutory exclusions in section 132 of the Code,[187] however, congressional action is needed here to establish such an exemption.[188]

Although, for reasons of administrative convenience, employees should not be taxed on the receipt of office supply coupons that they may use to make purchases that are personal in nature, we recommend that employers' deductions for office supply expenses that generate personal-use coupons for employees be limited. More specifically, we propose that the employer deduction for office supplies or similar purchases be limited by a small amount, such as ninety-five percent of the cost, whenever such expenditures generate rewards coupons redeemable for personal use by employees.[189] For example, if an employee were to purchase $100 of office supplies at Staples with a corporate credit card and were to earn a $10 coupon that he could use for any purpose he wished, his employer would be allowed to deduct only $95 for the office supplies. Denying a portion of the employer's deduction effectively imposes a small surrogate tax on the employer for the benefit inuring to the employee.[190]

Employers who wish to deduct 100% of the cost should be able to "opt out" by eliminating personal use of rewards coupons. For example, an employer could institute a policy that all rewards coupons earned through purchases on a corporate credit card or with reimbursed employee funds must be applied toward future business purchases.[191] In

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187. Even a coupon with a small face value (e.g., five dollars) would likely not qualify as a de minimis fringe under section 132 because it is "cash equivalent" and therefore presents no valuation difficulties. *See* Treas. Reg. § 1.132-6(c) (as amended in 1992).

188. One alternative would thus be for legislators to amend section 132 and provide for a specific exemption for cash coupon programs. Another option would be for legislators to amend section 132(e) to provide that rewards coupons qualify as de minimis fringe benefits, although this may encourage taxpayers to assert that other easy-to-value benefits should be similarly treated. A final option would be to amend Code section 102 and provide that the coupons constitute tax-free gifts to the employee. While section 102(a) generally exempts gifts from income tax, current section 102(c) specifies that this exemption does not apply to gifts made to employees by employers. Thus, legislators would need to amend section 102(c) to carve out the receipt of cash rewards coupons accorded by third-party vendors.

189. Congress could amend section 274 of the Code to provide for the ninety-five percent deduction limitation in this context. If rewards coupons were treated as excludable employee gifts under section 102(a), *see supra* note 188, then the ninety-five percent limitation might be added to Code section 274(b), which currently limits deductions for business gifts to twenty-five dollars. (The proposed deduction limitation would also technically apply to sole proprietors claiming a business deduction for their own office supplies; admittedly, in this context, its application would be more difficult for the IRS to enforce.)

190. *See generally* Jay A. Soled, *Surrogate Taxation and the Second-Best Answer to the In-Kind Benefit Valuation Riddle*, 2012 BYU L. REV. 153.

191. It is important to note that with respect to other expenditures that give rise to customer loyalty rewards (e.g., airline tickets, hotel rooms, and rental car purchases), a similar approach may

that case, there would be no personal benefit to the employee, and the employer should be allowed a full business deduction for the expense.

C. Taxing Mixed-Use Assets

Employer-provided internet service and cell phone use are currently enjoyed free of tax consequences by many employees.[192] This situation should not continue: a portion of the benefit representing personal consumption should be taxed to the employee. That portion should be determined by applying a fixed ratio to the total cost of the service, with an opt-out option available under specified conditions for employees. We draw this conclusion for several reasons.

First, like the use of customer loyalty rewards for personal travel, the receipt of free cell phone and/or internet access for personal use is clearly an accession to wealth that represents income. However, in contrast to customer loyalty rewards, valuation is not necessarily an issue for mixed-use assets. Consider an employer-provided cell phone that is offered by the employer for business reasons but that comes with no restrictions on personal use. Assume, as is typical, that the cell phone service contract provides for either unlimited calls or a high volume of minutes for a flat monthly fee, say $100 per month. At the end of the month, an accounting of all of the employee's personal calls versus business calls would reveal the ratio of personal time to total time spent using the phone. It seems logical, therefore, to assume that the ratio could simply be applied to the $100 fee to determine the monthly personal benefit to the employee. The same approach could be used for internet service as well.

However, the ease of valuing personal versus business use of mixed-use assets is slightly simplified in the above hypothetical. For example, some cell phone plans bundle services, so allocating costs among various features like phone calls, text, and data usage might be difficult. Consider a hypothetical cell phone plan that offers 500 minutes of calling time plus unlimited text messages for $100 per month. If an employee spends 200 minutes of time on work calls, 200 minutes on personal calls, and sends 50 personal text messages, how much of the $100 is allocated to personal use? What about an employee who spends 10 minutes of time on work calls and makes no personal calls but sends 500 personal text messages? Thus, depending on the bundling of various

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be taken: absent the employer eliminating personal use of such benefits, the amount deductible would be limited.

192. *See* SOC'Y FOR HUMAN RES. MGMT., *supra* note 7, at 22, tbl.D-1.

services, allocation issues might exist.

The bigger hurdle for mixed-use assets, however, is recordkeeping. Even assuming a relatively simple fee structure (e.g., $100 per month for phone calls only), making a monthly accounting of business versus personal calls constitutes a rather onerous requirement for a taxpayer. Without some kind of automated tracking system in place,[193] employees would either have to keep detailed logs or parse through their monthly bill to separate business and personal time. Employees may keep poor records and inadvertently make mistakes; or, worse, they may intentionally underreport personal use to their employers. Placing the burden on employers to track business versus personal use would be costly for the employer, and employees may view this as an invasion of their privacy.

To avoid these recordkeeping costs, in addition to the potential allocation issues in bundled service plans, policymakers should tax employees on a fixed percentage of the cost of mixed-use assets like smartphones. One option would be to adopt a 50/50 allocation, essentially assuming that the asset is used for personal purposes half of the time. This is similar to the approach that Congress adopted in section 274, which effectively treats business meals as having a 50/50 business/personal allocation.[194] Another option, which may be more politically palatable, is to adopt a more taxpayer-friendly approach and skew the allocation toward business use, e.g., 80/20. In the case of such an allocation, a taxpayer whose employer provided her a cell phone with unlimited calls and texts for a cost (to the employer) of $100 per month would be taxed on $20 per month.[195] The employer would report the

193. It is possible, however, that mobile applications could be used to automatically track business calls and provide summary information at the end of each month. Mobile apps today can track anything from how many times a user unlocks her phone during the day to the number of minutes spent on a particular website like Facebook. *See* Katy Hall, *These Apps Help You Realize How Much Time You Waste on Your Phone*, HUFFINGTON POST (Nov. 5, 2014), http://www.huffingtonpost.com/2014/11/05/apps-smartphone-use-_n_6096748.html [https://perma.cc/ELC6-7BEK].

194. Section 274 accomplishes this by limiting the deduction to the employer to fifty percent of the meal's cost, however, rather than taxing the employee. I.R.C. § 274(n) (2012).

195. Note that the fair market value of a fringe benefit is equal to the amount that the *employee* would have to pay for the service in an arm's-length transaction, and the *employer's* cost is not determinative. *See* Treas. Reg. § 1.61-21(b)(2) (as amended in 2012); *see also* I.R.S. Notice 2009-46, 2009-23 I.R.B. 1068, https://www.irs.gov/irb/2009-23_IRB/ar07.html [https://perma.cc/SVJ2-SXK9]. In the case of cell phone service, the employer's cost might be less than the employee's potential cost, particularly if the employer takes advantage of a group discount, which would result in slight undervaluation of the benefit to the employee. This undervaluation is not a bad result if a taxpayer-friendly approach is desired, but it may also justify using a 50/50 allocation between business and personal use rather than a more favorable 80/20 allocation.

income as additional wages on her pay stub and W-2 and withhold tax.

Adopting a fixed allocation should result in minimal costs for the employer and zero administrative costs for the employee. The employer already has access to the information regarding the cost of phone or internet access provided to its employees,[196] and applying a fixed ratio and adding it to monthly wages would be relatively simple.

Employees may object on the ground that a fixed allocation overtaxes them, particularly if they spend little personal time on employer-provided devices or if they would have otherwise purchased a cheaper plan for themselves. However, neither of these concerns carries much weight. First, employees should be able to opt out of mixed-use assets. In other words, if an employer provides a cell phone for business purposes, employees who wish to keep a separate cell phone for personal purposes[197] should be able to agree with their employer that the employer-provided phone will be used for business purposes only.[198] Such employees should not be subject to tax on their employer-provided phone.[199] Second, it seems unlikely that paying tax on a portion of an employer-provided plan would be more costly than purchasing one's own separate plan. Consider again an employee whose employer provides her with a smartphone that costs $100 per month, and assume she is treated as having $50 of income per month from the phone service under a 50/50 allocation. Assuming a marginal tax rate of thirty percent, the employee's monthly cost for the personal use of her phone would be

196. Even in the case of a service plan that provides service to numerous phones at an aggregate cost to the employer (akin to a personal "family plan"), employers should be able to prorate that cost among the number of phones provided with relative ease.

197. This might not be uncommon. For example, many employees may wish to keep personal communications separate for privacy reasons.

198. This would likely impose some additional administrative cost because, presumably, employers would have to periodically audit employee use or have a system to otherwise verify that the phone was not being used for personal purposes. This also leaves open the possibility of abuse by employees who might intentionally misrepresent that they will only use their employer-provided phone for business purposes. Employers could require employees to show proof of their own personal service contract (e.g., a monthly bill for the employee's personal cell phone) as a condition of avoiding tax withholding, but this would not help the individual who does not wish to use a cell phone for personal purposes at all.

The IRS and Treasury proposed a similar approach in I.R.S. Notice 2009-46, 2009-23 I.R.B 1069. Under the proposal, cell phone use would not be taxed if employers restricted usage to minimal personal use. All of the employee's use would be deemed to be business use if he could provide to his employer "sufficient records to establish that the employee maintains and uses a personal (non-employer-provided) cell phone for personal purposes." *Id.*

199. A cell phone provided for business use only would be an excludable working condition fringe benefit under section 132(d).

$15.[200] She is still likely to come out ahead economically in this scenario, as it is unlikely that she could purchase her own personal plan at a cheaper cost.

The fact that the tax on mixed-use assets would be withheld periodically makes income inclusion a particularly attractive policy choice in this context. Including relatively small amounts of income in an employee's paycheck each month and withholding tax would likely make the regime less psychologically painful for employees, who may not even notice a slightly smaller paycheck. As compared to taxing other types of fringe benefits, taxing mixed-use assets may therefore be met with less political resistance.

The parallels between mixed-use assets and business meals may suggest that an approach comparable to Code section 274 should be taken in the context of mixed-use assets, but a close examination shows that this is not the case. Rather, taxing employees on mixed-use assets but allowing them to opt out is a more sensible approach.

Like mixed-use assets, business meals paid for by an employer involve both a business element and a personal benefit. Section 274(n) addresses this issue by denying the employer a deduction for fifty percent of the cost of business meals, while the employee does not have income from receipt of the meal.[201] The result is a form of surrogate taxation, which effectively taxes a portion of the employee benefit by denying the deduction to the employer. Because the business and personal elements of a meal cannot be separated, employers have little choice but to bear the cost of the meal with a limited deduction.[202]

However, in the case of mixed-use assets, the business and personal elements can be separated. If employers were denied a deduction for some portion of the cost of unrestricted-use cell phones and/or internet service, it is likely that many would respond by simply restricting the use of the assets to business only.[203] Consider again the employer-provided cell phone that costs $100 per month for unlimited calls and texts. The out-of-pocket cost to the employer is the same regardless of whether it lets the employee make personal calls on the phone; but if the employer were denied a deduction and thus chose to restrict the use of the phone to business only, the cost would be fully deductible. It is,

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200. 30% x $50 income = $15 tax.

201. I.R.C. § 274(n) (2012).

202. Presumably, employers will only pay for meals that have a business benefit that exceeds the cost of the meal, taking into account the limited deduction.

203. The cost of cell phones and internet access restricted to business use only would be fully deductible under section 162. *Id.* § 162.

therefore, sensible for an employer to only offer phones or internet access with restricted use.[204]

The problem with this scenario is that an employee whose employer provides a restricted-use cell phone would be forced to maintain a separate phone for personal purposes. The employee might pay $100 per month for the same plan that the employer provides, resulting in $200 per month in total costs for duplicative services and no additional tax revenue to the federal government. This expenditure would constitute a deadweight loss to the economy. The best solution, therefore, would be to allow a full deduction for employers but to tax employees on the mixed-use assets, with an option to opt out if they chose to purchase their own cell phone and/or internet service instead of using the business technology for personal use.

Taxing a fixed portion of mixed-use assets is a departure from the IRS's current approach with respect to employer-provided cell phones, which is to treat most personal use as a nontaxable de minimis fringe benefit.[205] However, treating free personal cell phone service as a de minimis fringe does not comport with the modern realities of cell phone use. Recall that a de minimis fringe benefit is one with a value so small, taking into account frequency, that accounting for it would be "unreasonable or administratively impracticable."[206] While occasional cocktail parties and holiday gifts are de minimis fringe benefits, season tickets to sporting events and daily commuting use of an employer-provided car are not.[207] Having daily and possibly unlimited access to a free cell phone is more akin to having daily use of a car or regular seats at a baseball game than it is to an occasional meal or cocktail party. The vast majority of individuals today own a cell phone,[208] and having one's

204. Employers might restrict internet access by requiring login through an employer-provided portal that limits the user to particular websites. There are also a number of software programs that block specific websites and applications, which can limit personal use of employer-provided devices. *See, e.g.*, *Barracuda Web Security Gateway*, BARRACUDA, https://www.barracuda.com/products/websecuritygateway [https://perma.cc/CQ96-52LG] (last visited Apr. 16, 2016); *Web Filtering Software — Block Internet Access*, BROWSECONTROL, http://www.browsecontrol.com/web-filtering/ [https://perma.cc/HP2Y-4HUP] (last visited Apr. 16, 2016).

205. *See supra* note 115 and accompanying text. Although the IRS capitulated in 2011, two years prior it issued a notice seeking public comments on several proposals to tax personal use of employer-provided cell phones. *See* I.R.S. Notice 2009-46, 2009-23 I.R.B. 1068, https://www.irs.gov/irb/2009-23_IRB/ar07.html [https://perma.cc/SVJ2-SXK9] ("[T]o the extent the employee uses the employer's cell phone for personal purposes, the fair market value of such usage is includable in the employee's gross income.").

206. I.R.C. § 132(e).

207. Treas. Reg. § 1.132-6(e)(1)–(2) (as amended in 1992).

208. *Cell Phone and Smartphone Ownership Demographics*, PEW RES. CTR.: INTERNET, SCI. &

employer bear financial responsibility for this service is a regular and financially significant benefit.[209]

The fact that an individual employee may only occasionally use an employer-provided cell phone for personal use does not change the nature of the benefit. An individual who wishes to maintain even a bare-bones personal cell phone plan will likely have to pay at least $60 per month,[210] and it is likely that most employer-provided phones offer even greater benefits than a bare-bones plan. A free monthly gym membership offered by an employer is a taxable fringe benefit[211] even if the employee never goes to the gym or visits just once a month. Presumably, an employee whose sporadic use of the gym did not justify the tax burden would opt out of the membership altogether. Similarly, as noted above, employees who do not want to use their work phones for personal purposes can opt out of a mixed-use phone. But the reality is that most employees with employer-provided devices likely take advantage of this significant and valuable benefit, and the freedom to do so is still there for those who do not. This is yet another example of a benefit that highly compensated employees can currently enjoy free of tax consequences.

D. Taxing Workplace Lifestyle Enhancements

Workplace lifestyle enhancements (e.g., free dance lessons or yoga classes) do not fall within the ambit of working condition fringe benefits or de minimis fringe benefits and therefore should be taxable to employees. In fact, under current law, some lifestyle enhancement fringe benefits, such as free on-site meals provided to promote goodwill or morale in the workplace, are currently includable in employees' income.[212] However, due to administrative constraints, taxing employees directly on the economic value of such benefits is far from ideal.

TECH, http://www.pewinternet.org/data-trend/mobile/cell-phone-and-smartphone-ownership-demographics/ [https://perma.cc/XD42-6PAA] (last visited Apr. 16, 2016) (reporting that ninety percent of American adults own a cell phone and sixty-four percent own a smartphone).

209. For example, the annual cost to maintain a smartphone is generally at least $1200. *See* Brodkin, *supra* note 112.

210. The average cost of a cell phone that is not a smartphone is estimated to be $63 per month, while a smartphone costs around $100. Brodkin, *supra* note 112.

211. Section 132 excludes from taxation the use of on-site gyms but not employer-provided memberships at health clubs. I.R.C. § 132(j)(4); *see also* Treas. Reg. § 1.132-6(e)(2) (stating that athletic club membership is not a de minimis fringe benefit regardless of frequency with which employee uses the facility).

212. Treas. Reg. § 1.119-1(a)(2)(iii) (as amended in 1985).

Therefore, the best solution is a form of surrogate taxation in which Congress would deny employers' deductibility of such purchases.

A comparison of workplace lifestyle enhancements to other types of fringe benefits, from both the employer's perspective and the employee's perspective, highlights the details of why denying employers' deductibility is the best solution for taxation of lifestyle enhancements.

From the employer's perspective, lifestyle enhancements, unlike customer loyalty rewards, involve costs that are borne directly by the employer; thus, denying a deduction is a viable option here. Further, as compared to mixed-use assets, the nature of lifestyle enhancements is fundamentally different. More specifically, while a mixed-use asset such as a cell phone would commonly be offered for noncompensatory business purposes from the employer's perspective (e.g., to reach the employee at night and on weekends), lifestyle enhancements such as dance lessons are generally compensatory in nature. The former has an incidental personal benefit motivated by the employer's own business needs; the focal point of the latter is to enhance personal satisfaction, with the motivating intent to promote morale, attract and retain talent, and facilitate long hours at the workplace.[213]

There are fundamental differences from the employee's perspective, as well, that should inform the choice of policy. For most employees, an employer-provided cell phone that can be used for personal purposes eliminates a cost for service that the employee would otherwise incur. Mixed-use assets like cell phones and internet service are so commonly used that it is unlikely that a significant number of employees would be forced to consume services that they would not otherwise consume in their personal lives. But this is not necessarily true of workplace lifestyle enhancements. Consider an employer who provides on-site massages or free dance lessons. Would an employee otherwise consume those services? The answer is not as clear in this case. Some employees may take advantage of services that they would never otherwise "treat" themselves to, and others may even feel compelled to engage in employer-provided activities to be viewed as a "team player." In the latter case, employees might particularly object to being treated as having received income, which makes denying an employer deduction a more attractive option.

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213. In the case of employer-provided cell phones, the IRS has taken the position that phones offered to promote morale or attract talent are primarily compensatory in nature and, therefore, taxable. *See* I.R.S. Notice 2011-72, 2011-36 I.R.B. 407. Similarly, the fact that lifestyle enhancements are primarily compensatory in nature presents an even stronger case for taxation.

Denying an employer deduction for lifestyle enhancements is also preferable to taxing employees on the benefit because of the administrative difficulties involved in taxing the employees. There are two possible ways to tax employees on lifestyle enhancements, but both options involve problematic valuation or recordkeeping.

First, employees could be taxed on the value of the benefits made available to them at the workplace. If a Silicon Valley company provides free breakfast and lunch in the cafeteria, free massages, and free dry-cleaning services, an employee might be taxed on a fixed amount each month that represents the average use of all of those services. For example, the amount could be based on the average price of daily breakfast and lunch for one month added to the average monthly cost of massages and dry-cleaning services. To calculate these averages, employers might be allowed to make simplified conclusions, such as assuming that certain services are used once per month.[214] The problem with this approach is twofold: on the one hand, it is almost certain to overtax employees who do not frequently avail themselves of lifestyle enhancements offered at their workplace; on the other hand, those who most frequently avail themselves of these benefits may be undertaxed. As discussed above, the use of many of these services—dance lessons or yoga classes, for example—is not as ubiquitous as something like cell phone or internet usage. Taxing employees on the value of available benefits would not only be inaccurate in many cases but would likely be met with fierce political resistance.[215]

Another option for taxing employees would be to tax them on the value of only those benefits that they actually use. For example, an employee would be taxed on the fair market value of any free meal that he eats in the cafeteria and any dry-cleaning service that he uses in a given month. While this approach would be better targeted than taxing all available benefits, the recordkeeping and other administrative costs make it an unattractive policy. Tracking the cost of each individual meal consumed by an employee at work, for example, would likely be extremely burdensome for the employer.[216] While tracking less

214. For example, assume that employees can avail themselves of a thirty-minute Swedish massage at the office and that the fair market value of this service is $50. Further, assume that unlimited dry-cleaning services are offered and that the average monthly cost of dry cleaning in the employer's locality is $30. Employees would have additional compensation each month of $50 plus $30 if these services were offered at their workplace.

215. The exception might be free cafeteria meals. If many or most employees eat employer-provided meals as opposed to bringing meals from home, then taxing an average monthly cost would not necessarily overtax a significant number of employees.

216. On the other hand, it is possible that technology is or will eventually be available that would

frequently consumed benefits (e.g., dance lessons) would be less burdensome, it would still impose additional administrative costs that might not justify the revenue collected. Additionally, benefits that are infrequently consumed may be less likely to be perceived as income by employees,[217] and having inconsistent amounts of tax withheld month to month may be confusing to salaried employees.

Due to these valuation and recordkeeping issues, and due to the fundamental differences between lifestyle enhancements and other types of fringe benefits, a better approach in this context is to deny a deduction to the employer for all or a portion of the cost of the benefit. In that case, the employee would not have income upon receipt of the benefit. The result, in effect, would be a form of surrogate taxation where the employer is taxed on the benefit to the employee. Consider, for example, an employer that provides free dance lessons worth $100 to an employee. Under a system where such benefits were taxable to employees, the employee would include $100 of income and, assuming a marginal tax rate of thirty-five percent, would owe tax of $35. Under a system that instead denied a deduction to the employer, the employee would owe no tax on the $100 benefit. The employer, however, would lose the $100 deduction. Assuming the employer's marginal tax rate is also thirty-five percent, the employer would lose a $35 benefit, and the government would gain $35.[218] Under either scenario, the government receives a $35 benefit.[219]

Both scenarios are more beneficial than the current system, under which employers take deductions for lifestyle enhancements but employees do not include them in income;[220] however, denying the

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allow for fairly easy electronic tracking. For example, an employee could be required to take her meal to a register in the cafeteria to be itemized, and the cost could be electronically attributed to her via an employee ID number. The same system could be used for other workplace benefits. Employers could then make a monthly accounting of these types of benefits and add the appropriate amount of income to the employee's paycheck.

217. The assumption here is that although the benefit may be infrequently consumed, it is too valuable (or still consumed too frequently) to constitute a de minimis fringe benefit under section 132(e).

218. At a marginal tax rate of thirty-five percent, a $100 deduction would save a taxpayer $35 in tax and is thus economically equivalent to a $35 benefit to the taxpayer.

219. Of course, tax rates among employees and employers will not always be identical. In cases where employers' tax rates exceed employees' tax rates, denying employer deductions will generate more revenue than taxing employees. On the other hand, for employers with net operating losses or very low effective tax rates, denying employer deductions would raise less revenue than taxing employees at fair market value.

220. If the marginal rates for both the employer and the employee were thirty-five percent, then taxing the employee on a $100 benefit would result in a wash to the government because the $35 of tax collected from the employee would be offset by the employer's deduction, also worth $35. The

employer's deduction is a more practical approach in the case of lifestyle enhancements. Denying an employer deduction would vastly simplify the administrative burden of taxing lifestyle enhancements that are offered to multiple employees. This approach would obviate the need to keep track of actual consumption by various employees or to calculate average use for various types of benefits. No additional tax recordkeeping would be required at all. Although employers might object to losing deductions for these types of benefits, denying deductions to the employers who currently offer them—the Googles and Facebooks of the world—will be more politically palatable than taxing employees. Employers will likely undergo a cost-benefit analysis to determine if they will continue offering such benefits. If the cost of something like dry cleaning or yoga classes is not worth it to the employer without the benefit of a deduction, then presumably employers will shift to other, deductible forms of compensation.

Another option would be to deny employers some, but not all, of the deduction for the cost of lifestyle enhancements. As discussed above, this is the approach taken in section 274, which limits employer deductions for business meals to fifty percent of the cost. In the case of free on-site meals that are not eligible for exclusion under section 119,[221] section 274 may already limit the employer's deduction to fifty percent (at the same time, interestingly, that such meals are includable in employees' income).[222] In upcoming clarification regarding whether free

same would be the case for a system that denied a deduction to the employer (gain of $35 to the government) but did not tax the employee (loss of $35 to the government). However, both of those scenarios are better (by $35) than the current one, which involves a deduction for the employer (loss of $35 to government) with no offsetting tax collected from the employee. In other words, the current system puts the government at a revenue loss for each benefit conferred, equal to the value of the employer's deduction.

221. Under section 119 of the Code, on-site meals provided "for the convenience of the employer" are not taxable to the employee. *See* Treas. Reg. § 1.119-1(a) (as amended in 1985). Consider, for example, a bank that restricts employee lunch breaks to thirty minutes because of the high volume of customers during the lunch hour. If employees are unable to obtain lunch off-site in under thirty minutes, the bank can provide free on-site lunch to its employees without tax consequences to the employees. *Id.* § 1.119-1(a)(2)(ii)(b), 1(f) ex. 4. In the case of workplace lifestyle enhancements, free cafeteria meals would not qualify for exclusion under section 119 if they were not offered for the convenience of the employer, i.e., if they were not offered for a substantial noncompensatory business purpose. *See id.* § 1.119-1(a)(2)(i).

222. Free cafeteria meals that qualify for exclusion under section 119 are fully deductible to the employer, notwithstanding the fifty percent limitation under section 274(n) for deducting business meals. *See* I.R.C. § 274(n)(2)(B) (2012) (excluding de minimis fringes from the limitation); *id.* § 132(e) (including section 119 meals in the definition of "de minimis fringes"). But in the case of free on-site meals that do *not* qualify for exclusion under section 119 or section 132, the law concerning deductibility is somewhat unclear. If meals are taxable as compensation to employees, presumably they should be fully deductible under section 162 from the employer's perspective. To

on-site cafeteria meals at companies like Google and Facebook are taxable,[223] policymakers should also clarify whether section 274 applies to the employer. If it does, Congress may wish to implement a parallel scheme for other, comparable lifestyle enhancements that limits employer deductions to fifty percent while exempting the benefits from employee taxation.

Employers may argue that most lifestyle enhancements offered at the workplace are de minimis. However, it is important to note that the lifestyle enhancements discussed here—massages, dance classes, and the like—generally do not constitute de minimis fringe benefits under section 132(e). Recall that a de minimis fringe is a noncash benefit "the value of which [is] . . . so small as to make accounting for it unreasonable or administratively impracticable."[224] Generally, the frequency with which a benefit is provided to an employee is taken into account in determining whether the value is de minimis.[225] Thus, flowers, fruit, and similar property provided to employees "under special circumstances (e.g., on account of illness, outstanding performance, or family crisis)" are considered to be de minimis, while season tickets to the theater and daily commuting use of an employer-provided car are

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impose tax on the employees and limit the employer's deduction would effectively tax the benefit twice. However, on its face, the section 274(n) deduction limitation appears to apply because the exception for "expenses treated as compensation" under section 274(e)(2) covers "entertainment, amusement, or recreation" but does not reference meals. *See id.* § 274(n)(2)(A). On the other hand, the legislative history to section 274(n) clearly contemplates that meals treated as employee compensation should be fully deductible. *See* H.R. REP. NO. 99-426, at 124 (1985) ("[T]he cost of *a meal* or of an entertainment activity is fully deductible if the full value thereof is taxed as compensation to the recipients . . . ." (emphasis added)).

223. Treasury and the IRS have put "[g]uidance under [section] 119 . . . regarding employer-provided meals" on their 2014–2015 Priority Guidance Plan. *See* DEP'T OF THE TREASURY, *supra* note 146, at 10. Because section 119 does not apply in the absence of a substantial noncompensatory business purpose, the daily provision of free on-site meals (often of the gourmet variety) at Silicon Valley companies like Google and Facebook is likely at odds with section 119. The current practice, however, appears to be for many employers to not include these meals in employees' income. *See* Maremont, *supra* note 7.

The proper application of section 119 in this context is beyond the scope of this analysis and has been discussed elsewhere. *See, e.g.*, Givati, *supra* note 16; Lomax, *supra* note 8; Lundin & Cowan, *supra* note 8; Maremont, *supra* note 7; Richard Rubin, *No Free Lunch for Companies as IRS Weighs Meal Tax Rules*, BLOOMBERG TECH. (Sept. 4, 2014, 7:11 AM), http://www.bloomberg.com/news/articles/2014-09-04/no-free-lunch-for-companies-as-irs-weighs-meal-tax-rules [https://perma.cc/3VA6-3GM7]. For purposes of this discussion, we are focused on potential methods of taxing meals (and other lifestyle enhancements) that do *not* otherwise qualify for income exclusion under section 119, section 132, or some other Code provision.

224. I.R.C. § 132(e).

225. *Id.*; Treas. Reg. § 1.132-6(b)(1) (as amended in 1992). However, where it is administratively difficult to determine frequency with respect to an individual employee, frequency can be determined with respect to the entire workforce. Treas. Reg. § 1.132-6(b)(2).

not.[226]

As discussed in Section II.A, lifestyle enhancements have emerged as a way for employers to blur the lines between employees' business and personal lives in order for employers to attract talent and encourage workplace productivity. Thus, most of these benefits are available to employees on a daily or otherwise frequent basis rather than just on special occasions. This level of frequency would prevent lifestyle enhancements from being considered de minimis even if the fair market value of a single use of a particular service were small. Consider, for example, an employer that offers free laundry machines for personal use at the office. While a comparable service at a laundromat may only cost a few dollars for onetime use, free anytime use for all employees would not be considered de minimis.[227] Further, the Treasury regulations under section 132 emphasize the frequency with which benefits are made "available" to employees rather than the frequency with which benefits are "used" by employees.[228] Thus, free laundry services would not be considered de minimis merely because few employees avail themselves of the benefit.[229]

CONCLUSION

Twenty-first century fringe benefits present a significant challenge to the integrity of the income tax system. Currently, many fringe benefits go unreported, a position that the IRS commonly accepts and, to date, for which Congress appears to give its tacit approval. This laissez-faire approach is inequitable[230] and inefficient; and if it continues, taxpayer

226. Treas. Reg. § 1.132-6(e)(1)–(2). An occasional group meal or food at a holiday party would qualify as a de minimis fringe benefit under section 132(e).

227. An analogous example in the regulations is personal use of an employer copy machine. Such use is de minimis only if it is "occasional" and if the employer "exercises sufficient control and imposes significant restrictions on the personal use of the machine so that at least 85 percent of the use of the machine is for business purposes." *Id.* § 1.132-6(e)(1). This suggests that daily, unrestricted personal use of an employer's copy machine would not be de minimis.

228. *See, e.g.*, *id.* § 1.132-6(d)(2)(i)(A) ("Whether meal money or local transportation fare is provided to an employee on an occasional basis will depend upon the frequency *i.e.*, the availability of the benefit and regularity with which the benefit is provided by the employer to the employee." (emphasis in original)); *id.* § 1.132-6(e)(2) (stating that country club or gym membership not de minimis "regardless of the frequency with which the employee uses the facility").

229. Even if certain lifestyle enhancements are offered only on an occasional basis to employees, the fair market value of those benefits may still be too large for the benefits to be considered de minimis, although it is unclear exactly where to draw the line in value. For example, occasional theater and sports tickets are considered de minimis, but one-time weekend use of an employer's beach house is not de minimis. *Id.* § 1.132-6(e)(1)–(2).

230. *See supra* note 16 and accompanying text.

noncompliance in this sphere of the law is bound to have a significant corrosive effect in other spheres of tax compliance.[231]

When it comes to modern fringe benefits, Congress has several possible options that it should consider: exclude them from employee income, include them in employee income, or deny employer deductibility of such expenditures. In choosing among these three options, Congress should examine each fringe benefit carefully (or delegate this responsibility to the Treasury Department). In those cases when individual wealth accretion is minimal and little tax revenue is at risk, Congress should exclude the fringe benefit from income. But, as in most cases, when individual wealth accretion is significant and tax revenue is at risk, Congress should collect revenue from either the employee or the employer. When possible, Congress should tax income that inures to employees. And when employers make valuable fringe benefits available for personal use that are difficult to tax to employees, Congress should instead deny employers deductions for part or all of the concomitant expenditures that they incur.

Rather than focus on today's new breed of fringe benefits, some commentators might argue that congressional energies would be better spent focused on so-called big-ticket items, such as ascertaining the appropriate capital gain tax rates, the tax treatment of employer-provided health insurance as income, or whether residential mortgage interest should remain deductible. However, modern fringe benefits are a much larger revenue source than commonly presumed, and their lack of taxation necessitates immediate congressional attention. Congress should not dally; it should reform the Code to strengthen the integrity of the nation's tax system.

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231. *See, e.g.*, Ernst Fehr & Urs Fischbacher, *The Economics of Strong Reciprocity*, *in* MORAL SENTIMENTS AND MATERIAL INTERESTS: THE FOUNDATIONS OF COOPERATION IN ECONOMIC LIFE 151, 167 (Herbert Gintis et al. eds., 2005) (noting that "if people believe that cheating on taxes, corruption, or abuses of the welfare state are widespread, they themselves are more likely to cheat on taxes, take bribes, or abuse welfare state institutions"); *cf.* Zelenak, *supra* note 15, at 854 (arguing that "customary deviations [such as sanctioning the nonreporting of frequent-flier miles] may have contributed to an insufficient respect for the dictates of the Code on the part of high-level Treasury Department and IRS officials").